ECONOMIC SYSTEMS

A Comparative Analysis

REVISED

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PREFACE TO THE REVISED EDITION

This second edition of *Economic Systems* has been completely rewritten. I estimate that only about one third of the original formulations remained unchanged. The three main reasons for these changes were: (1) the desire to achieve greater clarity, (2) the elimination of descriptive materials, and (3) the addition of discussions of the social market economy and of the planning problems in underdeveloped countries.

The descriptive passages interrupted the analysis without being a sufficiently detailed treatment of the economies in question. The present chapters 19 to 21 cannot possibly be mistaken for a full description of the economies which were chosen for illustrative purposes. The character of the book is now uniformly theoretical.

I have come to the conclusion that in the developed countries of the West the old controversy of socialism versus capitalism is obsolete. We shall have to use the market mechanism but shall regulate the market economy to reach such aims as a more equal income distribution, high employment levels, monetary stability, and multilateral trade. The details of these regulations are no longer the subject matter of comparative economics. But I believe that comparative economics is absolutely essential as a basis for the selection of compatible aims and means. Once we have understood that the choice today is between totalitarian planning and a basically free but carefully regulated market economy, we can turn to the task of inventing those regulations and institutions which fit the nature of the market economy and avoid the dangers of totalitarianism. The type of discussion which I have in mind is to be found, for instance, in Dahl and Lindblom's *Politics, Economics and Welfare*.[1]

I am grateful to Professors Russel H. Baugh, of the Oklahoma State University, William B. Kelly, of the Fletcher School of Law and Diplomacy, Tufts University, John Perry Miller, of Yale University, and Mr. Lynn Turgeon, of Hofstra College, for their valuable suggestions, and particularly to Professor Ralph E. Fretty, of Saint Olaf College, for his untiring effort to improve the manuscript both in content and in style. I also want to thank Miss Dorothy Fox, of the Edwin Ginn Library of the Fletcher School, for her kind assistance.

George N. Halm

June, 1960

[1] Robert A. Dahl and Charles E. Lindblom, *Politics, Economics and Welfare* (New York: Harper & Brothers, 1953).

This book was written as a text for the course in Comparative Economic Systems which is now offered at many American colleges. Emphasis is placed on theoretical analysis rather than on a description of the economies of various countries. Institutional questions are, however, not neglected. Economic systems differ, are socialist or capitalist, planned or unplanned, according to their institutions. But since the number of institutional patterns is infinite, a purely descriptive approach would be most bewildering, in spite of its more practical appeal. The theoretical approach is more roundabout but, in the end, more rewarding. It establishes principles which can guide us through the maze of ever changing institutions.

I believe strongly that it is not the task of the economist to pass value judgments, but admit at the same time that it is next to impossible for a book on economic systems to achieve complete objectivity. Such a book will always be exposed to criticism from right and left, it will be censored as "socialist" by conservatives and as "bourgeois" by socialist writers. This cannot be helped; but I hope that a reasonably broadminded reader, though differing in many points from my views, will consider the book a fair introduction to the discussion of capitalism and socialism.

I did not undertake the task of writing a book on economic systems without years of preparation. I have been teaching the course, both in Germany and in the United States, since 1928, interrupted only by three years during which I was forbidden to teach it because I was not considered trustworthy under the Nazi regime. Since my student days in Munich I have been interested in the problems of socialism, stimulated by the contradictory theories of Gustav Cassel and Ludwig von Mises. The revolutionary conditions of the times added zest to the theoretical study of socialism, particularly for students in Munich, where socialist, communist, and national socialist revolts followed each other in the short space of five years (1918 to 1923).

The conclusion which I reached at the time was that a liberal socialist economy would face problems in the allocation of resources which it could not solve. I expressed these ideas in a small book, *Ist der Sozialismus wirtschaftlich möglich?*, published in 1929, which later formed part of the volume *Collectivist Economic Planning*, edited by F. A. Hayek in 1935. The formulations in this early tract were somewhat extreme and I no longer maintain all of them. It must be remembered, however, that these statements preceded the interesting arguments of such writers as Dickinson,

Dobb, Lange, and Lerner The reader of the present volume will see that I am still of the opinion that the arguments which Mises, Hayek and I had advanced in *Collectivist Economic Planning* are by no means completely refuted

George N Halm

January 1951

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PART ONE

THE SOCIAL ECONOMY

CHAPTER 1

COMPARATIVE ECONOMIC ANALYSIS

Introduction

Before World War I a book on comparative economic systems could not have been written. There was then only one economic system in existence in industrial countries: the private enterprise system called capitalism. Many books were published which compared capitalism with socialism. The subject matter of these books, however, was almost exclusively capitalism, capitalism attacked by socialists or defended against socialist criticism by "orthodox" economists. These books had little to say about socialism as an economic system because a socialist economy did not exist even on paper. Socialist thinking had not advanced to the blueprint stage; it was entirely critical and negative. This statement is particularly true of Marxism. Marxism is not a theory of socialism but a theory of capitalism which predicts the coming of socialism. Apart from a few scattered remarks of little weight, Marx left us completely in the dark regarding the nature of the socialist economy.

This situation has changed fundamentally. Today capitalism is an economic system among others. Russia has shown that a centrally planned economy is possible. Thus we have to deal now with at least two diametrically opposed systems: the essentially unplanned market economy of capitalism and the centrally directed economy of totalitarian socialism (communism).

Differences also exist within the communist and the free worlds. We know that tensions exist behind the iron curtain, but it is impossible to gauge these conflicts because totalitarianism tries to hide its internal dissensions. In the free world we discuss differences in economic philosophy, since controversy is implied in the very concept of freedom. Illustrative of diverging economic philosophies in the free world are the "social market

economy" on which Western Germany has based its recovery and the concept of a welfare state which underlies the economic program of the Labor party in Great Britain

However, even where so-called socialist governments have been established, the liberal or democratic form of their socialism has not (or at least not yet) changed the basic nature of the economies of the countries concerned the material means of production are still largely privately owned and controlled Liberal socialist systems with complete government ownership of the means of production and central planning do not exist today But the theory of liberal socialism has progressed, and several blueprints for such a liberal socialist economy have been drawn up

Capitalism, too, has changed and has become better regulated Policies have been designed which help maintain a high level of employment at reasonably stable prices, extreme inequalities of income distribution have been ironed out, and monopolies are under surveillance As a matter of fact, a comparison between capitalist economies, which are subject to such regulations, and socialist systems, which limit themselves to a modest degree of nationalization, shows a difference in degree rather than in basic economic structure We have to remember, however, that some socialists feel that they should move further in the direction of nationalization and planning Others (including some liberal socialist writers) feel that controls and regulations should be designed to influence the free decisions of the citizens only indirectly except where direct controls cannot be avoided Monetary and fiscal policies would be permissible according to this philosophy, but price controls, rationing, subsidization, etc should normally be avoided

To some extent we deal here with matters of terminology A comprehensive social security program, for instance, may be branded as "socialistic" though it may not basically alter the private enterprise system Capitalism is not necessarily a laissez faire system just as socialism need not imply a totalitarian central plan If, as some believe, the German economy under Hitler was still capitalistic, the capitalist economy can be totalitarian But was it then a private enterprise economy in the fullest meaning of the term 'private enterprise"?

Obviously, the different systems intermingle and overlap There are no clear-cut dividing lines This fact makes comparative economic analysis both difficult and interesting At first one might tend to simplify matters by cramming the available material into a few boxes, labeled capitalism, liberal socialism, totalitarian socialism (communism), totalitarian capitalism (fascism), etc Such compartmentalization, however, though very useful as a starting point, can also be dangerous It uses categories the mere mention of which awakens prejudice it tends to overstress what fits most readily into our boxes, and it discriminates from the outset against more complicated systems which refuse to submit to Proscrustean methods

Methods of Comparison

But how can we compare economic systems when we cannot even separate them cleanly from one another? The answer is that in the beginning we need not know more than the basic working principles of the different main types of economic systems. Such working principles presuppose certain aims and institutional arrangements. These we study to find out whether they are consistent and whether they remain consistent when they are being changed. This approach sheds light on all potential systems and tells us whether they are inherently logical in their construction or whether they are composed of incompatible parts and therefore "utopian."

Let us see how this approach compares with other possible methods.

One method of comparing different economic systems would be the selection of countries whose economies are considered typical for the systems we are trying to compare. The economy of the United States or of Western Germany would be used as an example of democratic capitalism; Germany under Hitler, of totalitarian capitalism; England under the Labor Government, of liberal socialism; Russia, of totalitarian socialism; Sweden, perhaps, of a mixed or middle-way system. This method would have the advantage of being a realistic approach. But its disadvantages would be considerable. It would set a task of such formidable magnitude that it could hardly be undertaken in one volume. And even if undertaken it would probably fail to achieve the desired result of bringing into focus the decisive differences. These can be understood only if we have criteria by which to select what is important for our purpose. A mere enumeration of policies and institutions would not materially aid our understanding unless we are guided by a theoretical analysis which can tell us what to look for. Supported by the knowledge of what socialism means economically, we may doubt, for instance, that the British economy is socialist in anything but the more distant goals of the Labor party. In discussions of Russia we would bog down in the kaleidoscopic change of institutions and policies during the last forty years unless we knew the essential problems facing the centrally planned economy. And in all cases it would be very difficult to disentangle the structural features of the economy which we are studying from transition difficulties (changes from war to peace, development of underdeveloped countries) or differences in wealth which from our point of view may be accidental.

Another approach could be suggested. We could take up, one after another, the typical economic problems with which the study of our own private enterprise system and its regulations has acquainted us. In each case we would ask whether this same problem is to be found in other economic systems and how it would be handled in these systems. We would study such problems as the allocation of productive factors to different industries,

consumers' demand, capital and interest, money and credit, the distnbutioo of income, competitioo and monopoly, incentives, management of productioo, and many other important questions This 'horizontal' approach can be quite useful, but only after we have become acquainted with the essential framework of the differeot systems If we do not know precisely on wbat assumptions the liberal socialist economy rests, bow can we determine wbether it bas to bave a pricing process for the purpose of economic calculatioo? If we do not know bow central planning works, bow can we understand tbe role whicb money plays in totalitarian socialism or what the function of the Russian State Bank is?

Obviously we must know first wbat the different systems whicb we want to study seek to accomplisb and wbicb institutions are considered necessary for this purpose In this classifying task we bave to use 'ideal types," models whicb are reasonably simple and whicb correspond roughly to ex isting classifications (capitalism, socialism, communism, fascism) More complicated systems, or systems whicb fall betweeo our classifications, can be eoosidered later oo After this "vertical" classificatioo has beeo accom plished, and after a desenption of the esseotial features of eacb system has beeo given, it becomes possible to use the above-meotioned "horizontal' method of studying the variations of a problem as it appears in the differeot surroundings of competing ecooomic systems Now, since a "vertical' classification bas preceded our "horizontal" cross seetions, this system of comparing the place and importance of individual problems within different systems can be used to much better advantage Likewise a study of the economies of differeot countries can now become fruitful because we know the aims and the proposed means for reacbing these aims and we can judge wbether means and aims are compatible and wbether the economy io question is internally consistent

We sball not follow slavishly any one of the methods discussed above but shall feel free to make use of all of them It seems obvious, however, that, on the wbole, "vertical' analysis must precede 'horizontal" and geograph ical methods of comparison To apply all three methods successively would involve too mucb repetition

Value Judgements

Comparative ecooomic analysis sbould be as free as possible from value judgements The aims of economic systems lie, strictly speaking, outside the province of economics If someone tells me that be cannot see why consumers sbould be left free to choose, I may not be able to convince him to the contrary Still, as an economist I can show that the cbances are that persons left free to choose will better be able to maximize the satisfaction of their wants

Other things remaining equal, the economist will prefer a high to a low nployment level, freedom of consumers' choice to dictatorial distribution, d a more equitable income distribution to excessive inequality. High emoyment helps to maximize the national product available for distribution, ee consumers' choice enables the consumer to reach the greatest satisfacon, and a more equal income distribution tends to equalize the imporance of the dollars spent by different persons.

Thus it may be possible for the economist to speak with a measure of uthority on certain aims as such (though his counsel may be overruled by ecisions which are based on entirely different considerations, such as nilitary necessity or the plans of a dictator). Yet even between aims which re desirable from the economic point of view a conflict may arise. Free consumers' choice, for instance, can make it more difficult to reach a sustained high level of employment because an economy which has to adjust production to ever-changing demand conditions tends to be more unstable than an economy in which the product is forced upon the consumers. Or, to use another example, full employment policies may cause dangerous inflationary pressures. Then the question will arise which aim we should stress—high employment levels, free choice of consumption, or monetary stability—and this political decision cannot be made on scientific grounds alone. The economist will be able to show, however, that price inflation is dangerous or that repressed inflation leads to restrictions in the freedom of the consumers and to misguided allocation of the means of production. Similarly, the economist can point out that free choice of occupation and equal per capita distribution of the national income are incompatible.

When the economist studies different economic systems he does it not so much to prove that the ends of one system are better than those of another. He does it mainly to find out whether the aims conflict, whether the means are likely to accomplish the aims, whether different aims or means are mutually incompatible, whether they compete for the same resources or whether they tend to support each other harmoniously.

The economist may well be able to show that the desire to achieve one end cuts down the possibility of achieving the competing end. A well-known example is offered by the desire for both protection and tariff revenue. The more protective a tariff is, the less revenue the government receives. Or take a policy to protect bondholders against falling security prices. If we force the central bank to buy all government securities at fixed prices, we force it to create money whenever securities are offered for sale. The result may be price inflation which hurts the creditor. Thus the policy may have achieved stable bond prices at the cost of general price inflation.

A clear-cut case of an incompatibility of aims is shown in the following example. Suppose that we favor the introduction of a social system which is to rest on three basic principles: everybody is free to choose his occupation; wages are completely uniform; and consumers' choices determine the

direction of production Clearly, we can have a combination of two, but not of all three, of these principles Free choice of consumption will necessitate constant shifts of labor from industry to industry With free choice of occupation such a change can be accomplished only through wage differentials, i e , different industries must be able to compete for labor by offering higher wages A uniform wage scale, therefore, implies allocation of labor by command Free choice of occupation must then be relinquished Or we maintain free choice of occupation together with the guarantee that the same wage is paid irrespective of the kind of work performed The variety of consumers' goods produced under these conditions would be strange indeed, corresponding to what workers want to produce instead of what consumers want to buy

Should the reader consider this example rather childish, it must be stated that such inconsistent combinations of aims can frequently be found in socialist literature and that we do not even have to limit ourselves to that part of it which is known as utopian

We see that the economist can perform a useful service within the strict confines of his discipline, i e , without having to indulge in value judgements regarding what the ultimate ends of economic life should be The economist should be cognizant of this area in which he can work objectively however strong his private predilections may be Ideally speaking, he should devote himself to the calm study of facts and laws in the fields where his scientific methods can be employed "Of the desirability of keeping one s study and analysis as uninfluenced by personal desires, as objective as possible, there can be no doubt' [1] As Arthur Schopenhauer once said, we have to try to approach our problem with unharnessed will (*mit abgeschirrtem Willen*) This should mean at least that we do not enter a discussion of the relative economic merits of different economic systems with an unshakable conviction that everything belonging to one system is better than anything that belongs to another

Small indeed is the danger that this attempt toward objectivity will let us remain forever in a wavering state of indecision As human beings, we prefer one system or another, particularly when we feel that not all systems are equally compatible with our political ideals

As a rule the reader of a book on economic systems does not have difficulty in ascertaining the social-economic philosophy of the author In this respect the reader is fortunate because he can then make the necessary adjustments As a matter of fact, since perfect objectivity is hardly achievable

[1] F St L. Daly, "The Scope and Method of Economics *Canadian Journal of Economics* XI, No 2 (May, 1945), 169 See also Barbara Wootton *Lament for Economics* (New York Holt Rinehart and Winston, Inc, 1938) 'However extensive or limited a view any particular economist may take of his normative functions all would agree that failure to distinguish between normative and positive propositions is wholly unpardonable An 'ought must be plainly labelled as such and in no circum stances slipped in under cover of an 'is or a 'might be'" (pp 135 136)

in comparative economics, the writer should make his basic preferences clear. The author of the present volume believes in the philosophy expressed by J. M. Keynes in the last chapter of his *General Theory.*[2]

Importance of Comparative Economic Analysis

Now that we have become acquainted with comparative economic analysis, it is not difficult to list our reasons for studying different economic systems.

(1) Through comparative economic analysis we gain a better knowledge of our own economic system. By comparing it with other systems we see it as a whole and become aware of its framework, its working mechanism, its distinctive features. Particularly, we become conscious of the fact that some economic policies are conducive to the system, spring naturally from its basic assumptions, and are compatible with its aims. Other policies prove to be alien to the system, do more harm than good, and lead, as by chain reaction, to further interferences which eventually endanger the functioning of the economy.

(2) Comparative economic analysis can warn us not "to take our economic system for granted and to assume that another would begin with all the advantages which exist already." [3] In reality, the change from one system to another may destroy the delicate adjustments which have been worked out by the forces of the market. If the market is destroyed and nothing is put in its place, the result will be chaos. Yet this very mistake was frequently made in socialist literature. Instead of trying to show how the market forces could be replaced (by an artificial price-setting process or by a central plan), some authors simply assumed that the destruction of capitalism would somehow abolish most economic problems. The breakdown of the Russian monetary system immediately after the revolution was hailed by some communist writers as the transition to real communism, but it soon became obvious that the new system needed a stable monetary unit as badly as did the old. Russia's experiences have destroyed this naïveté which characterized most of the older socialist literature. We know now that the planning of the production and distribution process of a whole country is an immensely complicated task. Comparative economic analysis can therefore help those who want to create a new economic system; by showing them how to draw up blueprints, it may cut down considerably the cost of experimentation.

(3) Comparative economic analysis will lead to a better appreciation of certain theoretical and institutional questions. Some economists consider

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[2] John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (London: Macmillan and Co. Ltd., 1936). See also the discussion of Keynes' philosophy in the last chapter of the present volume.

[3] R. L. Hall, *The Economic System in a Socialist State* (London: Macmillan & Co. Ltd., 1937). p. 105.

the institutional setup of capitalism still to be the only logical framework for the study of economics, others try to transcend the institutions of the free private enterprise system to prove the general applicability of the principles of the market economy, still others emphasize the importance of growth over the equilibrium concepts of the market economy and want to replace the forces of the market through the central planning of development Only comparative analysis permits us to see these important issues in their proper perspective

(4) Comparative economic analysis acquaints us with systems which are basically different from our own The East West conflict makes it imperative that we be able to judge with reasonable accuracy the productive capacity and the rate of growth of the economies of our totalitarian adversaries To those who want the private enterprise system to continue, the success of total planning should be more interesting than its shortcomings If it is true that planned economies can maintain full employment, then capitalism cannot permit the spreading of the disease of mass unemployment, because mass unemployment will not be tolerated any longer, when Russian planning succeeds in putting the first satellite into space, we must discard the myth that bureaucratic regimes are always technologically backward

(5) Comparative economic analysis should even try to find out what the totalitarian socialists of Russia think about capitalism, since their theorizing may determine their actions Because official Russian analysis of capitalism professes to follow strictly Marxian lines, the interpretation of Russian thinking must rest partly on a knowledge of Marx's ideas about the breakdown of capitalism

(6) Comparative economic analysis can be helpful in our international economic relations We must learn that the reactions of others to our foreign trade policies may be the result of an economic philosophy that differs from ours For instance, our trading partners may not be interested in nondiscriminatory trade, because the monopolistic advantage of their state trading implies discrimination In our relations with underdeveloped countries we must be conscious of the fact that such countries want to develop their economies in a hurry and that at least some of them are greatly impressed by the fast growth of Russian heavy industry What do we have to offer in this competition of basic economic philosophies? If there is a convincing answer to Russia's challenge it will in part have to be furnished by comparative economic analysis

CHAPTER 2

THE SOCIAL ECONOMY

Robinson Crusoe

In all economic systems the basic problem is the allocation of scarce means among competing ends for the achievement of maximum results. Even a person living in complete isolation would have to solve this problem. Robinson Crusoe has to allocate the very limited resources at his disposal (including his own labor) among the many different tasks which he plans and performs to satisfy his wants. A detailed study of his decisions could fill a volume which would acquaint us with such fundamental economic concepts as marginal utility and disutility, saving, capital goods, consumers' goods, and so on. Robinson Crusoe has to decide which goods he is going to produce with his limited resources, and he will obviously try to achieve the combination of goods from which he can derive the highest satisfaction of his wants. His considerations will include not only present wants but also future wants, plus the well-known fact that he may increase his future consumption substantially if he first produces instruments which improve the productivity of his labor. But while the making of instruments (capital goods) increases his future productivity, it leaves him at present with fewer goods for immediate consumption because he has diverted part of his energies from consumers' goods to capital goods production. We take it for granted that Robinson Crusoe uses all the resources at his disposal which he cares to use and that he will continue to work until the disutility of working an extra quarter of an hour outweighs the marginal utility of the additional product.

Robinson Crusoe's economic decisions are relatively easy to make because his brain is able to register all the data upon which his decisions depend. His economy is relatively simple because it depends on two sets of data only: those given by his natural surroundings and possessions

(which influence his wants and provide the material resources with which to satisfy them), and those given by his personality (his wants, ability, industriousness, foresight, etc) His decisions do not require the support of price and-cost calculations He is able to allocate his labor and his material resources to the best advantage because he knows what the different satisfactions, present and future, mean to him and because he knows implicitly the discomfort caused by more work or a lengthened period of waiting for future consumption He balances, without difficulties and often unconsciously, psychic quantities which, if they were to concern different people, could never be compared in the same matter-of-course way

Robinson Crusoe does not use money, he cannot buy or sell, he cannot go bankrupt or become unemployed The concepts "capitalism" and "socialism' have no meaning for him His economy is perfectly isolated and, therefore, no part of a social economy

The Social Economy

Production in a social economy is a process in which millions of people cooperate These persons have specialized their functions in order to increase the efficiency of production and in the process become mutually interdependent Together they create a social product which, owing to the advantages of specialization and cooperation, is many times greater than the aggregate result of isolated individual efforts of an equal number of persons could ever be But the interdependence of millions of individuals in one gigantic process of cooperation raises many difficult questions Robinson Crusoe knew all the relevant data and allocated his labor and resources in one comprehensive decision This comprehensive decision is no longer possible in the social economy No single person any longer knows all the data the available resources, the techniques of production, and the wants of the people In order to organize production and in order to distribute the total product among the members of the social economy, many problems have to be solved, consciously or unconsciously, with or without a general plan

Production in a modern industrial society is a very intricate process whose ramifications and interrelations elude detailed description Think of the millions of persons who contribute to the production of consumers' goods such as bread, razor blades and newspapers, to say nothing of automobiles and houses, of the materials and machines used in manufacturing these articles, of the machine tools which made the machines, of the steel which went into the tools, of the huge productive apparatus of a steel mill, and so forth ad infinitum How does this collective effort, whose different branches and stages are interdependent to the point of utter complexity, result in the production of just the right kinds and numbers of

commodities? How do the millions of individual activities gear into each other with not too much waste and friction? And how is the total product to be distributed among those who participated in this cooperative effort?

Before we try to answer these questions it is advisable to formulate precisely the problems which must be solved in a social economy. We state these problems without reference to the economic organization of the social economy, i.e., independently of the social-economic system that might be chosen.

(1) Somehow it must be decided *what* is going to be produced. In addition we must know *how much* of each product is needed. Since the productive resources can be combined in unending variations, our choice is great, at least in the long run. Total production, however, is limited. Increased production of one commodity means decreased production of another.

(2) We must decide *how* to produce the commodities on whose production we have decided. As a rule, different techniques can be employed. A bridge can perhaps be made of wood, stone, or steel, and similarly most other products can be made by a variety of methods. With given technical know-how the economic decision will depend on the relative scarcity of the factors used. If wood is relatively abundant and steel scarce, it may well be advisable to settle for a less durable wooden bridge to save steel for other production processes in which steel is either more essential or entirely irreplaceable.

(3) In a growing economy part of the productive resources must be set aside for capital goods production. Capital goods help create more consumers' goods in the long run. In the short run, capital goods production reduces the output of consumers' goods. Somehow it must be decided how far to restrict present consumption in favor of capital accumlation. Though listed separately, this problem is only the most important subdivision of our first problem (of *what* to produce). With the second problem (of *how* to produce) it is connected by the fact that production methods often differ in as to the amount of capital goods which are being employed in connection with labor.

(4) Problems (1) to (3) have to be solved in such a manner that all the interdependent production processes are properly balanced. The complexity of the problem is rather staggering. Let one integral part of this cooperative process of social production lag behind, and potentially all the others will suffer. The rule applies to the supply of raw materials, of trained labor, of intermediate products, and even of consumers' goods, since without a sufficient production of consumers' goods labor may be less efficient than desired.

(5) We should be able to take for granted that the social economy makes "full" use of the available resources and particularly of the labor supply. Experience has shown, however, that some societies have been plagued

by open or "disguised" unemployment. Thus it seems justified to list "full use of available resources" as one of the problems of the social economy What exactly we mean by "full' use of available resources will have to be discussed later on

(6) The total product of the social economy, the result of the cooperative effort of millions, will have to be distributed. Each member of society must get his share With this problem we return to our first problem, since in order to know *what* to produce we must know *for whom* we produce

(7) Whatever the social system, human beings must make the necessary economic decisions and human beings must carry them out And since human beings do not react by means of biological instincts, they must somehow be induced to do the right things at the right time if the production process of the social economy is to function Whether and to which degree self-interest is to be used is a most important practical question The problem of motivation can be expressed as the question *why* the members of the social economy act as they do

In listing the problems of the social economy, we have been careful not to refer to any special type of social economy (capitalism, socialism, etc) In trying to suggest solutions to such problems, however, we shall have to make assumptions concerning the nature of the social economic system

The Basic Alternatives

It may seem natural to assume that the process of cooperation in a social economy should be predetermined in detail in one comprehensive master plan, so that each stage and branch of production will fit the other stages and branches, and so that the most economical techniques will be employed In other words, we may be inclined to compare the social economy with a huge factory whose input is the total productive effort of the nation and whose output is the social product

But the modern industrial economies of the West do not correspond to this picture of a huge, centrally directed factory Nobody plans the economic life of these nations, their citizens are, as a rule, free to act as they please, and the stages and branches of production gear into one another without conscious management

We shall see how each of these alternatives solves the seven problems of the social economy First, however, a word concerning the philosophies on which the choice of one alternative over the other is based.

To avoid a study of precapitalist forms of economic society (which is now becoming important again in the study of poor economies and the reasons for their underdeveloped state), we begin with Adam Smith's often quoted passage on the 'invisible hand" The passage occurs in a chapter

in which Smith, discussing "restraints on particular imports," tries to show that it is, in almost all cases, either a useless or a hurtful regulation "to direct private people in what manner they ought to employ their capitals." He therefore also argues against restraints on imports. In this context he suddenly makes the celebrated remark which more than any other highlights his economic philosophy and that of his followers down to the present day. This is the famous passage:

> . . . every individual necessarily labors to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. . . . The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would no-where be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it.[1]

We must note that Adam Smith obviously referred only to economic policies such as those practiced by mercantilist statesmen and that he could not have visualized a case of total central planning in a modern society.

It may now be interesting to contrast Smith's statement with that of a modern writer. Joan Robinson in her popularization of John Maynard Keynes' *General Theory* makes the following remarks:

> Under a system of private enterprise it is, in a simple and obvious sense, the decisions of employers—in the main, industrial entrepreneurs—which determine the amount of employment offered to the working population, but the entrepreneurs themselves are subject to general influences which cause them to decide one way or another, and the decisions of each influence the decisions of the rest. There is no central control, no plan of action, and whatever actually occurs in

[1] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. Edwin Cannan (London: Methuen & Co. Ltd., 1925), I, 421.

> economic life is the result of innumerable independent individual decisions The course which it is best for each individual to pursue in his own interests is rarely the same as the course best calculated to promote the interests of society as a whole, and if our economic system appears sometimes fantastic or even insane—as when foodstuffs are destroyed while men go hungry—we must remember that it is not surprising that the interaction of free individual decisions should lead so often to irrational, clumsy and bewildering results [2]

Lest Joan Robinson's statement be taken as an expression of Lord Keynes' own philosophy, it is only fair to add the following passage from the latter's posthumous article "The Balance of Payments of the United States," which expresses the following qualified endorsement of Adam Smith

> In the long run more fundamental forces may be at work, if all goes well, tending towards equilibrium, the significance of which may ultimately transcend ephemeral statistics I find myself moved, not for the first time, to remind contemporary economists that the classical teaching embodied some permanent truths of great significance, which we are liable to-day to overlook because we associate them with other doctrines which we cannot now accept without much qualification There are in these matters deep undercurrents at work, natural forces, one can call them, or even the invisible hand, which are operating towards equilibrium If it were not so, we could not have got on even so well as we have for many decades past [3]

An unbiased reader of *The Wealth of Nations* will find that Adam Smith did not believe in complete laissez faire He did believe, however, that the forces of the market lead to full-employment equilibrium Lord Keynes showed that they may not always do so and warns us to watch that part of our productive resources are not left idle, that the equilibrium we achieve is not an underemployment equilibrium

Joan Robinson's criticism goes much further She suggests that the course which it is best for the individual to take is *rarely* the course best calculated to promote the interests of society as a whole, and she implies that the activities of individuals ought to be coordinated by central planning

Central planners, of course, will side with Mrs Robinson They do not marvel at the wonder of automatic and unconscious cooperation, they em-

[2] Joan Robinson, *Introduction to the Theory of Employment* (London Macmillan & Co Ltd., 1938), p 2

[3] John Maynard Keynes "The Balance of Payments of the United States," *Economic Journal*, LVI (June 1946), 186

phasize the negative features of the market economy: possible discrepancies between saving and investment, disequilibrium, unemployment, monopoly, and the fact that the distribution of income may be so unequal that the wants of many are not properly satisfied.

This last argument is so basic that it can be used against the market economy even when it performs to perfection in every other respect. The planners, furthermore, may argue that static economic equilibrium (even full-employment equilibrium) is less important than economic growth and that growth ought to be planned and not left to private decisions concerning saving and investment.

Once central planning is chosen in preference to the market economy, the whole system is fundamentally changed. For the time being we must leave as an open question whether the planned or the unplanned system is more productive or more amenable to economic growth. It is clear from the outset, however, that central planning must reduce the scope of private decisions. The planned economy abolishes private investment decisions and may affect the free choice of consumption and of occupation.

Depending on our basic philosophies, we may see more merit in one system than in the other. We may also feel that both systems have their good and their weak points and that, accordingly, we should try to combine the best features of both. Whether and to which extent such an undertaking could be successful comparative economic analysis has to find out. Complicated interrelations are to be considered. They will emerge as soon as we ask how the two diametrically opposed systems, the free market economy of the private enterprise system and the master plan of totalitarian socialism, propose to answer the seven questions outlined above.

The Market Economy

The question of *what* commodities (and *how much* of each) are to be produced is in the private enterprise economy decided on the basis of revenue estimates and cost calculations of privately owned business firms. Assuming the demand for a product as given (once problem 6 has been solved) and assuming that we know the techniques of production, the private firms decide not only *what* and *how much* but also *how* to produce. Costs are known because the resources are privately owned and sold by their owners for the highest price the market will bear. Competition on both the markets of the products and the markets of the factors of production leads to prices which equalize demand and supply; and, as for the products, such prices will, in the end, cover costs without profit or loss. Profits will lead to increased supplies, and losses to reduced supplies, until equilibrium between supply and demand is achieved at a price which does not suggest any further adjustments.

It is not to be assumed that all these private decisions are always correct, merely that through a process of trial and error a state of equilibrium will come about if no further change in the relevant data occurs

It may seem strange that the private enterprise economy can solve the fourth problem regarding the integration of mutually *interdependent* production processes, in view of the fact that these production processes are undertaken by *independent* private firms But these firms are connected through the market, and changing prices of both inputs and outputs lead to continuous adjustments and adaptations The result is indeed astonishing the complicated process of interrelating thousands of production processes is accomplished without central direction The result is remarkable even when we admit that the integration is achieved with friction and waste by a trial and-error process

Now we have to turn to the problem of distribution, the question *for whom* we produce *what* The distribution problem is solved by the same market mechanism which supplies the data for cost calculations Since the productive resources are found in private ownership, the distribution of such ownership and the market prices paid for the productive contributions determine, between them, the personal income of the members of the free enterprise economy Needless to say, personal incomes, so determined, differ greatly, and the system can be criticized for its inequality of income distribution It is important to note, however, that the recipients of money incomes are free to buy, within the limits of their income, what they fancy *and that the production process adjusts itself to changes that occur in the wishes of the buyers* It should be pointed out that some of the difficulties and frictions in the market economy are caused by the marked degree of freedom which the consumers enjoy

The freedom of consumers' choice extends to the choice between present and future consumption. Members of the free market economy are free to save part of their income This saving permits the production of capital goods which contribute to the growth of the economy For the important adjustment of investment to saving, the free market economy relies on changes in interest rates We remember that, in his cautious endorsement of Adam Smith, Lord Keynes spoke of "doctrines which we cannot now accept without much qualification" This qualification concerns difficulties which arise in the free market economy when intended savings exceed intended investments It can be shown that reductions of interest rates do *not always* lead to the desired result of equalizing saving and investment The free market economy therefore cannot be relied upon to solve our fifth problem (concerning the "full" use of resources) It needs monetary and fiscal controls which influence the free decisions of its members indirectly, without direct interference through a central plan

Our seventh problem (concerning motivations) is easily answered by reference to the profit motive or, more generally, the desire of the members

of the market economy to improve their position, to charge for their contributions to the production process the highest price the market will bear. This tendency is fraught with monopolistic dangers, but if competition can be maintained the motive power of self-interest is constantly recharged, because nobody is secure enough to relax his efforts.

The Centrally Planned Economy

In discussing the operation of a centrally planned economy, we must make first some assumptions concerning the system. To distinguish it to the utmost from the free market economy, we postulate: a dictator who determines the aims of the plan; government ownership of the material means of production; allocation of labor by command; and management of production by government officials who fulfill predetermined production quotas.

In this system (which does *not* correspond to the present Russian economy), the seven problems would be handled in the following manner:

The aims of the plan (e.g., quickest industrialization, modernization of agricultural production, relocation of industry, armament production) would have to be translated into technical details, such as new steel mills or transportation facilities. Since capital goods "compete" with consumers' goods for the limited supply of the factors of production, the plan would have to be all-inclusive. *What* is to be produced and *how much* would have to be worked out according to the aims of the plan, the available resources, and the need for proper balance and integration of the interdependent production processes. The consumers must abide by the dictator's decision regarding the quantity and quality of the consumers' goods; labor must carry out its job wherever needed; and the managers must meet their production quotas. If one industry does not "fulfill," other industries will not have the necessary materials or machines. We must assume that the centrally planned economy has to insist that its commands are being strictly obeyed.

It is perhaps not entirely impossible to envisage such a command economy without the use of money. Most likely, however, the planned economy will use money to compare heterogeneous input with output, to check on plan fulfillment when deliveries are paid by money transfers in the State Bank, to balance total wages against the total value of available consumers' goods, and to facilitate the distribution of consumers' goods.

The plan determines the amount of capital accumulation. A turnover tax, for instance, may raise the prices of consumers' goods far enough above their costs to cut the consumers' demand down to the size of the available supply.

The intricacies of industrial integration are solved by input-output equations and, in practice, by considerable trial and error. It is difficult to see

how the question of the choice of the most economical techniques of production is to be answered in a system which does not rest on market prices The prices that may be set by the plan have no guiding function and are not necessarily a true expression of the value of the product or the factor If the problem of *how* to produce cannot properly be solved in the planned economy, this would constitute a serious weakness On the other hand, it may be taken for granted that the planned economy makes "full" (though not necessarily the most economical) use of its resources and that it can push development or growth more, since it can enforce a reduction in consumption which the consumers would not permit if they had any voice in the matter

The planned economy envisaged above would do away with most of the freedoms which characterize the market economy of free private enterprise The consumers would perhaps be permitted to choose among the items which the government had decided to produce But the government would not endanger the consistency of its difficult planning procedure by trying to follow the changing whims of the consumers The freedom of the individual to invest in plant and equipment would be abolished

If labor should be allocated by command, the question *why* people work is already answered It may be, however, that command is a rather poor way of inducing labor to the greatest effort, particularly in agriculture, where labor often works in solitude The planned system may compromise, therefore, and try to induce greater effort through wage differentials Wage differentials can also be used to guide the labor supply into the right industries Such a method would introduce free choice of occupation into the centrally planned economy but deprive the planned system of the possibility of fulfilling the ideal (if this should be the ideal) of equal income distribution

The fact that the dictator sets the aims of the totalitarian economy simplifies the task, inasmuch as one person's decisions replace the varying decisions of millions But we must remain conscious of the fact that the ease of the dictatorship economy is not as simple as that of Robinson Crusoe's economy Robinson knew all the data required for his decision The dictator, on the other hand, it not superman enough to know even the smallest fraction of the data required for a successful coordination of production in a centrally planned economy Though the ends are set by the dictator, the allocation of the material resources and of labor in a social economy is a most complicated task which, in the absence of a comprehensive pricing process, will need for its accomplishment an immense bureaucratic apparatus

Mixed Systems

All economic systems in practice are "mixed" in the sense that the predominantly free systems contain elements of planning and that the planned systems make use of monetary incentives and of monetary accounting procedures. However, economic literature discusses under the name of mixed systems specifically economies (real or potential) which combine the features of free consumers' and occupational choices with government ownership of, at least, the "strategic" industries, and a fair amount of central planning. Later on we shall study interesting blueprints which suggest a mixture of pricing and planning, and also practical attempts toward such a compromise. Whether these mixed systems function well or badly will depend on the compatibility of their different aims and on the adequacy and practicability of the proposed means.

CHAPTER 3

THE FREE MARKET ECONOMY

A Model of Capitalism

The free market economy, which we are about to study in somewhat greater detail, is neither the economy of present day capitalism nor a system of laissez faire Laissez faire capitalism is characterized by a minimum of government interference While the free market economy, too, leaves government interference out of consideration, it differs from laissz faire capital ism in the following respects (1) it is an abstract system rather than a real one, (2) it is an ideally competitive economy, (3) the factors of production are easily, without friction, moved from one industry to another The free market economy, in other words, represents a *model* of capitalism As an unplanned economy it is characterized by the following assumptions

(1) The factors of production (labor, land, capital) are privately owned, and production takes place on the initiative of private enterprise

(2) Income is received in monetary form through the sale of services of the factors of production and from profits of private enterprise

(3) The members of the free market economy have freedom of choice with respect to consumption, occupation, saving, and investment

(4) The free market economy is not planned, controlled, or regulated by the government The government satisfies collective wants, but it does not compete with private firms, nor does it tell the people where to work or what to produce

A study of the free market economy will prove useful, but it will not be sufficient to allow us to evaluate capitalism, because our assumptions are by far too abstract Present-day capitalism will have to be the subject matter of a more detailed investigation The abstract picture of the free market economy will show, however, how capitalism would perform, as an ideal

type, where the basic assumptions upon which the capitalist system rests are found in pure condition.

This may seem to be the wrong approach. Why should we try to idealize a system with whose weaknesses we are well acquainted? Two answers to this question can be suggested. One is that the present-day capitalist system is not a pure system, that it has been adulterated, and that its bad features may be the result of impurity rather than the consequences of its basic characteristics. A study of the free market economy will reveal what capitalism would be like if it performed perfectly, on its own terms, without any admixture of alien elements. The other answer is that this approach to capitalism is permissible in view of the fact that modern socialist theory treats socialism in the same abstract and idealistic fashion. Sometimes the *abstract* or *ideal* socialist economy, which we come upon in modern blueprints of socialism, is compared with the *real* capitalism of today—a comparison which is hardly proper. If socialism is treated as an economic system in the abstract, we should at first use the same method in studying the basic organizing principles of capitalism.

Families, Firms, and Dollar Ballots

The free market economy is not regulated by a central planning board. The members of such an economy are not told where to work or what to produce, nor does the government control their consumption. They are free to choose their jobs (within the limits of training and ability) and free to spend their income on whichever commodities they prefer to buy. If they should decide not to spend their income but to save it, they are free to do so.

Where there is no central plan, the direction of production has to rest with many private economies which are, as it were, the points of crystallization of the market economy. Of these private economies we can distinguish two types. The first type is *the consuming unit, the family*. It receives a money income through the sale of the services of the factors of production (labor, land, and capital) which are in its private possession. To these sources of income (wages, rents, and interest payments), we have to add profits (dividends) which the consuming unit may derive from its share of ownership in the producing units.

The second type of private economy is *the producing unit, the firm*. The firms are owned by, and are operated for, the consuming units, but they have, nevertheless, a life quite their own. Whether small grocery stores, farms, or giant steel corporations, the business units have this in common: they combine the services of the factors of production (which they buy from their owners) in technical processes in order to turn out commodities

or services which they sell on the market The commodities and services are bought either by other firms or by the consuming units The families receive the money income with which they buy through the sale of productive services to the business units

The business units translate the consumers' demand for commodities into a demand for labor, natural resources, and capital goods, i e, into a demand for the services of the factors of production which are owned by the consuming units These factors can be used for the production of a great variety of commodities, and it has to be decided in which fields of industry they shall be employed This decision depends on what we can call the consumer's ballot As the demand for a commodity increases, its price will rise, other things remaining equal The producer of the commodity, who wants to expand production because he anticipates higher profits, will be able to offer higher prices for the services of the factors of production He is able to outbid less fortunate producers As the consumers shift from coal to oil, the producers of oil burners will hire the men who used to produce coal furnaces Of course, we cannot be sure that the factors needed for the expansion of one industry are the same as those set free by the contraction of the other In the long run, however, the necessary adjustments will take place in spite of temporary frictions

The consumer is free to spend his money on whichever commodities or services he decides to buy Since his total purchases are limited by his personal income, each purchase is made at the expense of foregoing other purchases The consumer's final choice will depend on (a) his individual circumstances and tastes (age, sex, education, cultural background, size of family, etc), (b) his personal income, (c) the part of his income which he wants to spend on consumers' goods (his personal income minus his savings), (d) the prices of the commodities and services which he is actually buying, and (e) the prices of other commodities and services whose purchase he is considering

In making his choice our consumer casts his dollar ballots Though his decisions may seem insignificant for the economy as a whole, the similar decisions of millions of others, to buy or not to buy at given prices, determine whether more or less of these commodities and services shall be produced An increasing demand for an article, the willingness on the part of the consumers to spend more money on it, will increase the seller's profit And since the seller wants to maximize his profit, he will expand his production A seller, however, whose product has not met with the approval of the buyers, faces decreased demand, may have to sell at a loss, and will either have to curtail his production or to stop it altogether

Thus we see that, by their willingness to pay higher or lower prices for different commodities and services, the consumers actually direct production in such a way that the factors of production are employed in pro-

ducing the commodities from which the consumers hope to derive the highest satisfaction.

Here a basic weakness of the free market economy becomes apparent. Since the market counts the dollar of the poor and the rich alike, we are in the free market economy very far from the ideal (if this should be the ideal) of a uniform restriction of the satisfaction of wants. While individual consuming units within the market economy try, as best they can, to maximize satisfaction within the limits of their incomes, no maximazation is even attempted for the economy as a whole.

In order to achieve maximum satisfaction of wants for the entire economy, the following difficulties would have to be overcome:

First, wants of different persons would have to be made comparable in relation to their respective urgency. This condition cannot be fulfilled. The nearest possible approach to a solution is the use of money. The willingness to spend an equal amount of money on the part of two persons could be said to indicate wants of equal importance.

Second, it has to be understood that this approximation to an interpersonal comparison of the intensity of wants requires that different persons have the same amount of money to spend. But perfect equality of per capita income is not found and cannot be found in the free market economy.

Third, it might be argued that most people do not even know what is best for them and that a staff of experts or a benevolent dictator would be better able to maximize people's satisfactions. It is obvious, however, that this solution could be attempted only in a centrally planned, and not in a free market, economy.

When we say that the consumer directs production in a free market economy, we seem to ignore the fact that the consumer does not, as a rule, contract for his goods in advance; he buys what is already on the market. The solution to this problem has been given by Frank H. Knight. The consumer, he argues,

> . . . does not know what he will want, and how much, and how badly; consequently he leaves it to producers to create goods and hold them ready for his decision when the time comes. The clue to the apparent paradox is, of course, the "law of large numbers," the consolidation of risks (or uncertainties). The consumer is, to himself, only one; to the producer he is a mere multitude in which individuality is lost. It turns out that an outsider can foresee the wants of a multitude with more ease and accuracy than an individual can attain with respect to his own. This phenomenon gives us the most fundamental feature of the economic system, *production for a market.*[1]

[1] Frank H. Knight, *Risk, Uncertainty and Profit* (Boston: Houghton Mifflin Company, 1921), p. 241.

While the consumer does not contract for his goods in advance, he has at least a veto power in the form of not buying, which, in the long run, helps to guide production according to his wishes

Saving and Investment

We have seen that the producing units translate the demand of the consumers into a demand for the services of the factors of productioo They buy these services in order to produce consumers' goods The consumers' goods are bought by the families, who in turn receive the income with which they buy through sales of their services to business firms While money is constantly paid out by business units to consuming units (flowing from firms to families), it is spent by the families on commodities and services produced by the firms, thus flowing right back to the firms only to be paid out again for new services needed for continued production processes

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We see that money remains in the market and that it flows incessantly from firm to family and from family to firm in a never-ending circle The services and commodities, on the other hand, flow through the market, disappear in consumption, and are replaced by the output of a continuing productive effort

If the consuming units save part of their income, we have to change our simplified picture of the money flow

Suppose that these savings are instantly invested, that they are used to finance the production of new capital goods by business firms in the capital goods industries Capital or investment goods (such as tools, machines, raw materials, and factory buildings) are goods which serve production rather than consumption purposes With their help we are able to increase the *future* output of consumers' goods, but we must remember that, at full employment, we can produce capital goods only at the expense of a reduction of our *present* consumption below an otherwise possible maximum

Savings, when invested, do not interrupt the money flow from family to firm The saved up portion of the earned income is being spent on capital goods by the firms which borrowed the savings In the production of these capital goods income is earned just as in the production of consumers' goods Our model of the circular flow of money remains, therefore, basically correct The saved part of the earned income of families is given to firms as loans, is spent by the firms on the products of other firms (in the capital goods industries), which also make income payments to families

Were it not for the fact that the families save part of their income, the total expenditure on consumers' goods would tend to be greater than the supply of consumers's goods at cost prices, because the families' income is now earned in producing both consumers' and capital goods and therefore

larger than the value of the consumers' goods. We see that the process of saving has made it possible to increase the productivity of the economy through the creation of more and better productive equipment. Productive resources, which would have been devoted to consumers' goods production had the families insisted on spending their whole income on consumption, are freed through the process of saving, thus permitting the production of additional investment goods which will turn out more and better consumers' goods in the future.

The assumption that savings will promptly be invested rests, in our model of the free market economy, on the fact that an increased supply of savings will, other things remaining equal, lower the price of loanable funds, i.e., the rate of interest. At a lower rate of interest the business units are supposed to borrow more funds than before because their investment activities depend on the relations between the rate of interest and the anticipated rates of profit.[2]

Acquisitiveness and Competition

In the free market economy, all sellers of goods and services (including labor) try to obtain the highest price possible. Likewise, all buyers of goods and services seek to pay the lowest price possible. Thus, while all private economies are dependent on exchange, they are at the same time concerned with getting as much as they can out of these exchanges. Since, as a rule, there are always several would-be sellers and several would-be buyers present, the acquisitive tendency, which aims at the payment of low prices and the receipt of high prices, is counteracted by the fear of competition, which produces a readiness to accept, if necessary, lower prices and to pay, if necessary, higher prices. Acquisitiveness and competition together are responsible for the establishment of prices at which demand and supply are exactly equal. Each unit of the free market economy trades on two markets. The family is a buyer of consumers' goods and a seller of productive services; the firm is a buyer of productive services and a seller of consumers' goods. And on each market buyers as well as sellers fight on two fronts: against the person with whom they are bargaining and against their competitors.

Acquisitiveness and competition are the driving forces in the free market economy, which is therefore sometimes referred to as a profit economy or a competitive economy. We assume at present that competition is not hampered by monopolistic tendencies. Competition is assumed to be free, perfect, and pure.

[2] A fuller discussion of the circular flow of money can be found in George N. Halm, *Economics of Money and Banking* (Homewood, Ill.: Richard D. Irwin, Inc., 1956), Chap. 2.

What we have called the acquisitive tendency is often referred to as the profit motive That we have chosen the broader term is due to the fact that the profit motive of the business unit finds its counterpart in a similar attitude on the part of the consuming unit In both the business and the consuming unit this acquisitive attitude leads to the same results it urges the units to aim at the highest possible gains, not only in buying and selling but also in consuming and producing

The Trend toward Equilibrium

The pricing process of the free market economy represents itself as a series of reciprocal price relations which have the tendency of bringing the economy to a state of equilibrium This state will have been reached when every factor of production is employed where it is paid the highest possible price, where it satisfies the most powerful demand in terms of dollars In this state of equilibrium prices can no longer change of themselves, i e , without a preceding change in the price determinants which lie outside the pricing process

Demand is determined not only by prices and incomes but also by the primary scale of values of individual human beings Supply likewise has ultimate determinants that are largely independent of prices (1) the supply of the factors of production (size and composition of population, natural resources and capital goods) and (2) the technical know how that exists at any given time

The ultimate causes of disequilibrium in the free market economy are therefore changes in human needs (which, however, are measured only according to the purchasing power with which they are endowed), changes in the supply of factors of production, and changes in technical know-how These changes offer new scope for acquisitive and competitive activities, and there is, again, a tendency for a state to be reached which represents the new optimum position for all private economies (the consuming and the producing units) under the new conditions

The working of the price mechanism can best be shown if we assume, first, that equilibrium exists, next, that this equilibrium position has been disturbed, and if we then watch the price adjustments which lead back again to equilibrium

Suppose that a new technique permits a lowering of the unit cost of production through a substitution of capital for labor The equilibrium position which existed is now disturbed because (1) the demand for the factors of production has been changed, (2) the incomes of the owners of the factors are affected, (3) the change in incomes alters the demand for consumers' goods, (4) the price of the product has been lowered through cost reduction and competitive pressure, (5) a change in the price of one

commodity tends to affect the demand for other commodities, (6) this change in demand for commodities again affects the demand for factors and the incomes of the owners of the factors—and so on ad infinitum.

The demand for loanable funds increases, since the new technique uses more elaborate machinery. The rate of interest tends to rise. The total demand for labor will momentarily fall off because of the substitution of capital for labor. But lower wages and higher rates of interest may, in time, induce other firms, whose production techniques have not changed, to substitute labor for capital. Competition will lower the price of the product, which can be produced more cheaply than before. Whether total expenditure for this product will increase, fall, or stay the same will depend on the elasticity of demand. If total expenditure for the product changes, there will also be a change in the demand for other products, owing to the absorption or release of purchasing power in the buying of the cheapened product. The above-mentioned changes in income will lead to further changes in demand.

Production and factor allocation will have to adjust themselves to all these changes; and as production follows the consumers' demand, as it expands and contracts, the original price changes will reverse themselves because of these adjustments. This is true for the commodity markets as well as for the factor markets. The price changes will not cease as long as there is room for the private economies to improve their positions through further changes. For the consumer, equilibrium is reached where the marginal utility of the products bought corresponds to their price; for the seller of productive services, where he cannot sell at a better price all he wants to sell; and for the businessman, where his return is just enough to keep him in business with no tendency to expand or contract production.

Technically, the free market economy performs very well indeed. This fact is not surprising, since we have assumed away all complications and frictions. It is a full employment economy because we endowed it with the power to shift the factors of production with ease from industry to industry and because we assumed instantaneous investment of all forthcoming savings. To praise results which were implied in our very assumptions would be foolish.

And yet it is worth while to consider that we have before us a model of a social economy which solves its problems without conscious leadership, without a central plan of action. Each person in this economic society sees only a tiny section of the whole and acts as though all prices were given. But all persons taken together, driven by their desire to gain and their fear of losing, solve problems of whose complexity they are not in the least aware.

Shortcomings of the Market Economy

The consistent relations which are maintained between all prices in a free market economy are more than merely a convenient assumption for the benefit nf a simplified mndel The whnle lngic of the market economy depends nn them We shall see that, far from belittling tbis aspect of tbe market economy, liberal socialist writers are rather eager to show that the *socialist economy* could be based *on the same consistent pricing* process which is found in the free market econnmy The socialists however, cannot claim and do not want to claim that the wnrking of the price system would be automatic in socialism We nnte that in a free market economy nobody "sets" the prices In a socialist economy the prices nf the material means of production would have to be set and frequently adjusted by the government, because the market forces would not be able tn work automatically where the government owns the material means of prnduction Of this mnre later

The driving power of the free market economy is not the command of the government If it were, it would be incompatible with the unplanned character of the free market economy By the very logic of the system, the private economies can be relied upon to act precisely as required The model of the free market economy includes the driving power of the profit motive and the checking power of competition While abstract, the model will work on its own terms without requiring conscious guidance

That the free market economy offers a degree of freedom of action which the members of a planned economy could not enjoy is quite obvious It is important, however, that we recognize the qualified nature of that freedom Free choice of consumption, as well as of nccupation, does not mean too much for the person whn has a very limited amount to spend on consumption and on education The free choice, furthermore, is limited to the alternatives nffered nn the market We can sell nur services nn the market nnly for the prevailing market price and not for what we wnuld like tn get, and we cannot sell at all where nn demand exists

Even the ideal free market econnmy is clearly an ecnnomy in whicb income is distributed very unequally And since we have left the gnvernment entirely nut of the picture, we cannnt very well introduce it now to bring about a more equal income distribution It is therefore essential that we do not fall into the error nf claiming mnre fnr the free market ecnnomy than is implied in its assumptinns

The member nf tbe free market economy is "free" alsn in the negative sense that nobndy is respnnsible fnr him and that he is not responsible for nthers Let *him* be unemployed nr bankrupt, and *he* will have to bear the cnnsequences This negative aspect of our mndel carries little weigbt, bow

ever, as long as we assume its perfect functioning. Unemployment will occur only rarely and only for short periods.

Finally, it must be stated that the relations between the members of the free market economy are antagonistic rather than harmonious. The private economies meet as buyers and sellers, as employers and employees, and as competitors. The free market economy solves the problems of the social economy without demanding any social integration other than through the "invisible hand," which works via competition rather than through conscious cooperation. Whether such competition is good or bad is not for the economist to decide.[3]

The Appendix explores the question of whether the pricing process of the tree market economy can be applied to economic systems other than capitalism. The degree of abstraction of this discussion and, accordingly, its difficulty are greater than that of the rest of the book. But if the Appendix can be mastered, it will repay the effort by an increased insight into the problems of factor allocation, which must be solved in all social systems. It will, e.g., be useful for a better understanding of the basic problems of central planning (to be discussed in Chapters 18 and 19) or for a clarification of the difference between personal and functional distribution (to be discussed in Chapters 5 and 17).

[3] Some passages of this chapter followed the formulations used in the author's contribution "Further Considerations on the Possibility of Adequate Calculation in a Socialist Community," to *Collectivist Economic Planning*, ed. F. A. Hayek (London: George Routledge & Sons, Ltd., and Kegan, Paul, Trench, Trubner & Co., Ltd., 1935), pp. 131-200.

PART TWO

CAPITALISM

CHAPTER 4

THE CAPITALIST ECONOMY

Introduction

In Chapter 3 we discussed the free market economy which we considered a model of capitalism. Now we must try to enumerate and evaluate the characteristic features of capitalism as it exists today. Even this picture cannot be fully realistic, however. It can be, as it were, only a map of reality. We must remain conscious of the fact that the economies of the capitalist countries differ in their factor endowment, their history, and (most important in the context of our investigation) the economic activities of their governments. Some countries have gone further than others in their endeavor to regulate the private sector of the economy or in their desire to expand the public sector. Indeed, these deviations from the model of the free market economy may become so important that the economy in question looses gradually the most distinctive feature of capitalism: the absence of a central plan.

We have already used the term "totalitarian capitalism" or "fascism."[1] This system differs basically from the type of capitalism now under discussion and will find its proper place in our treatment of the totalitarian systems.[2] We eliminate also what has been referred to as laissez-faire capitalism. None of the existing capitalist economies corresponds to this somewhat vague concept; indeed, it may be doubted that it ever was a good description of the existing state of affairs in the past.[3]

The discussion will be broad enough to cover the basic features of the

[1] See Chapter 1, above.
[2] See Part V, below.
[3] Cf. T. S. Ashton, "The Treatment of Capitalism by Historians," in *Capitalism and the Historians*, ed. F. A. Hayek (Chicago: The University of Chicago Press, 1954), pp. 33-63.

industrial economies of the West which are not guided by a central plan The case in which peacetime regulations are so numerous that they impair the working of the price mechanism, but not numerous enough to use the terms "socialist" or "centrally planned," will be discussed later on.[4] Another type which mixes features of the market and planned systems is that of underdeveloped countries in the process of development It will be discussed in Chapter 22 [5]

Absence of a Central Economic Plan

The economies of the capitalist countries rest, in the main, on the independent (but interdependent) individual actions of millions of private economies These actions are not coordinated by a central plan Market prices, on which the decisions and calculations of the consuming and producing units are based, are, as a rule, not set by the government, under competitive conditions they are the result of market forces However, prices may be set by private firms in instances of monopolistic or oligopolistic power Since we face here a very important deviation from the principles of our competitive model of the free market economy, we must pay close attention to the monopolistic features of capitalism

Absence of a central plan does not constitute a case of laissez faire The government of a modern capitalist country has important tasks to fulfill These tasks can be divided into two major functions (1) The government has to see to it that communal wants are properly satisfied These are the wants for the satisfaction of which a price either could not be charged to the individual (national defense, or flood control) or ought not to be charged (public education) (2) The government has to see to it that the actions of the private economies are properly regulated The government ought to establish healthy monetary and credit conditions, to maintain an aggregate demand which is neither too large nor too small, and to see to it that monopolistic powers are kept in check We shall become acquainted with these regulatory activities of the government Here it is only important to emphasize that they do not constitute a central plan and that they need not interfere with the price mechanism or the economic freedom of the private economies On the contrary, the real market economy can function satisfactorily only when sound monetary conditions are maintained, when recessions are prevented from developing into depressions, and when a sufficient degree of competition is upheld

Needless to say, the governments in capitalist countries do not always limit themselves to these indirect controls which support the working of the price mechanism, often they interfere clumsily and haphazardly with market

[4] See Chapter 21, below
[5] See pp 285 296

pricing, without a sufficient understanding of the working principles of a free economy. From these misdirected government activities we need not draw the conclusion that the government sector of the capitalist economy ought to be as small as possible. It is essential, however, that the price system be supported by indirect controls and not replaced by direct ones.

Consumers' Sovereignty

It should be clearly understood that free choice of consumption in capitalism has the full meaning of consumers' sovereignty. Even in a centrally planned totalitarian economy the citizens may be given a money income and permitted to buy freely (without ration cards) whatever they may be able to procure at set prices. This freedom of consumers' choice, however, does not constitute consumers' sovereignty, unless the effects of these purchases on consumer goods prices are used as a guide for future production.

Whether the principle of consumers' sovereignty should be adhered to is a most basic question whose implications far transcend the field of economics. Indeed, one may well ask whether the consumer is a wise or a stupid sovereign.[6] Much TV advertising seems to presume the latter. Nevertheless, was not John Maynard Keynes right when he said that the greatest loss of the homogeneous or totalitarian state was the loss of personal choice? [7] As economists we cannot answer these questions. But should we decide for consumers' sovereignty, we argue strongly for the capitalist market economy, because our freedom of personal choice is more securely embedded in a private enterprise system than in an economy where the government owns the material means of production. The very existence of centralized power endangers consumers' sovereignty, because those who have the duty and the power to plan are invariably tempted to substitute their (supposedly superior) decisions for the wishes of the consumers. Barbara Wootton reminds us that

> the temptation to exact unnecessary cultural uniformity is always likely to be strong among those men and women who are personally responsible for making the decisions which constitute economic planning. It will be strong because it is, generally speaking, easier to plan for uniformity than for diversity. It will be strong because people who arrive at positions of power are, inevitably, people who enjoy the ex-

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[6] See, e.g., Alfred R. Oxenfeldt, *Economic Systems in Action* (New York: Holt, Rinehart and Winston, Inc., 1952), p. 15. Cf. also John Stuart Mill, *Principles of Political Economy* (New York: The Colonial Press, 1899), Vol. II, Book 5, Chap. 11, paragraph 8.

[7] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan & Co. Ltd., 1936), p. 380.

ercise of power This is, of course, as true of the powerful whose intentions are good as of those whose designs are evil [8]

Socialists claim that consumers' sovereignty has little meaning in capitalism, owing to the unequal income distribution Thus, if a defender of capitalism speaks of the dollar ballots which guide production, the socialist will answer that considering the much larger number of votes the rich can cast, capitalism cannot be considered a true consumers' democracy Indeed, we ought not to forget that ' wants which cannot clothe themselves in money are left undetected and unsatisfied and [that] the luxurious fancies of the rich exert a stronger pull on the productive resources of the community than the stark needs of the poor " [9]

Free Choice of Occupation

In capitalism the individual is free to choose his job, but he is limited in his choice by ability, training and the existing market conditions Free choice of occupation implies that, in order to attract a sufficient supply of a special kind of labor to an industry, where this labor is more urgently needed than elsewhere, wages must be high enough to exert the needed enticement Free choice of occupation, therefore, is incompatible with equal income distribution When attempts are made to make the income distribution within a market economy somewhat more equal, care must be taken lest the allocation process be disturbed

Wage differentials and unequal income distribution have a tendency to perpetuate themselves to some degree Scarcity of a given quality of work caused by expensive and time consuming training, leads to higher income out of which further expensive education for one's children can be paid This suggests that in the field of education can be found one of the most productive approaches toward a greater equality of opportunity and, eventually, of income

We must emphasize that free choice of occupation does not imply a "right to work " Free occupational choice may mean little in an economy suffering from prolonged mass unemployment Then jobs might not be available for those who are qualified and are willing to work at prevailing market wages [10] It has sometimes been argued that, at sufficiently low wages, em

[8] Barbara Wootton *Freedom under Planning* (Chapel Hill The University of North Carolina Press, 1945), p 31

[9] D H Robertson, *The Control of Industry* (London Cambridge University Press 1923), p 87

[10] We must add that unemployment can be of the "voluntary" type where those offering their services are not willing "to accept a reward corresponding to the value of the product" attributable to the marginal product of a unit of labor See Keynes, *op cit*, p 6

ployment could always be found for all who are willing to work. That such an oversimplified application of demand-and-supply analysis is not justified will be shown in Chapter 8. Situations can arise when wage cuts will not increase employment but will actually make matters worse.

Unemployment means that the wage earner is potentially insecure. If millions are exposed to protracted unemployment, they may be tempted to choose a centrally planned system in preference to capitalism, even though the security of the totalitarian system may be that of the barracks. Adolf Hitler's rise to power during the mass unemployment of the early 'thirties ought never to be forgotten.

Karl Marx suggested that the laborer in the capitalist system is "free in the double sense, that as a free man he can dispose of his labor-power as his own commodity and that, on the other hand, he has no other commodity for sale, is short of everything necessary for the realization of his labor-power." [11] Marx wanted to show that, lacking the modern instruments of production, the laborer, though a free agent, has to sell his services to the owner of these instruments, the capitalist, at the lowest possible wage, i.e., the wage that just permits the laborer's subsistence and reproduction Marx's argument was wrong. Capital, in turn, depends on labor. But it is true that labor had first to establish its proper bargaining power through association—a point which was clearly seen by Adam Smith.

Marx was the first to emphasize another point which is of importance for a realistic appraisal of the capitalist economy. He pointed out that, once he had sold his labor power, the worker was no longer free during the labor day but under the command of his capitalist employer. We must remember, however, that a changeover from a market economy to a centrally planned economy would not alter the dependent status of most workers and that it may still be better to work for a private firm (whose domination one may escape), than for the all-powerful state.

Socialist writers followed Marx in pointing out that freedom in capitalism suffers from the fact that "the bulk of workers find themselves divorced from the ownership of the instruments of production in such a way as to pass into the position of wage earners, whose subsistence, security and personal freedom seem dependent on the will of a relatively small proportion of the nation." [12] William H. Beveridge excludes, for the same reason, from his list of essential liberties in his free society the "liberty of a private citizen to own means of production and to employ other citizens in operating them at a wage." This liberty, he says, "is not and never has been enjoyed by more than a very small proportion of the British people," and he is willing to abolish private property if this should be necessary for the achievement

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[11] Karl Marx, *Capital: A Critique of Political Economy* (Chicago: Kerr & Company, 1906), I, 187-188.

[12] Sidney Webb and Beatrice Webb, *The Decay of Capitalist Civilization* (New York: Harcourt, Brace and Company, 1923), p. 2.

of full employment[13] Beveridge is conscious of the fact that, together with private property, he would abolish private enterprise and capitalism However he does not tell his readers how the freedom of his society could then be maintained under government ownership of the material means of production

Free Enterprise

Free choice of consumption and occupation imply private ownership of consumers' goods and of labor The freedom of private enterprise necessitates private ownership of the material means of production Without these property rights it would be next to impossible to have an unplanned economy just as a central plan cannot be in operation where private property *in its full meaning* exists If private property is to mean more than the right to income from ownership of land and capital, if it is to mean the right to control to dispose, to invest—then private property and the unplanned economy are inseparable

The unplanned character of the capitalist economy, furthermore, implies freedom of individual initiative Where the government does not coordinate the productive efforts of the citizens, such coordination must be the result of the activities of private enterprise

Where the business unit is small (in the farm, the store, the small manufacturing plant even in the small corporation) the owner controls the productive process, develops entrepreneurial initiative, makes profits and incurs losses as the case may be This is no longer true, however, for the big corporation where management may easily be divorced from ownership where shareholders are entitled to income when profit is made, but where management and entrepreneurial initiative are delegated to hired functionaries The "owners" are, in this case, not very different from those who merely lend their savings at fixed rates of interest It has been said that the development of the modern corporation has resulted in "the dissolution of the old atom of ownership into its component parts, control and beneficial ownership" and that "this explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use "[14]

These conclusions weaken somewhat the argument that profits are always made and allocated to produce a maximum of individual initiative We cannot even be sure that what individual initiative is forthcoming will be di-

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[13] William H Beveridge *Full Employment in a Free Society* (New York W W Norton and Company Inc 1945) p 23

[14] Adolf A Berle Jr and Gardiner C Means *The Modern Corporation and Private Property* (New York The Macmillan Company, 1933) pp 8, 9

rected toward increased efficiency and not toward devices by which management may enrich itself at the expense of ownership.[15]

Berle and Means believe that

> . . . for the tens and even hundreds of thousands of workers and of owners in a single enterprise, individual initiative no longer exists. Their activity is group activity on a scale so large that the individual, except he be in a position of control, has dropped into relative insignificance. . . . Group activity, the coordinating of the different steps in production, the extreme division of labor in large scale enterprise necessarily imply not individualism but coöperation and the acceptance of authority almost to the point of autocracy. . . . At the very pinnacle of the hierarchy of organization in a great corporation, there alone, can individual initiative have a measure of free play.[16]

These statements are important for a realistic interpretation of capitalism. But we cannot agree with writers for whom this situation (the "managerial revolution") obliterates the essential differences between the various economic systems and who argue that in all systems the managers are the ruling class.[17]

It is true that, with respect to the internal functional division of labor, there is much similarity between the big private corporation and a nationalized industry. The mistake lies in the confusion of this *internal* division of functions with the problems of *external* relations. The capitalist manager makes free investment decisions which are based on cost-price relations; the public manager in a centrally planned economy fulfills prescribed production quotas as the plan commands. In this respect there is a world of difference between the capitalist manager and the public manager.

Having stressed the importance of the big corporation in modern capitalism, we hasten to add that there exist hundreds of thousands of private

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[15] That the theory of Berle and Means is not altogether new is shown in the two following quotations. Alfred Marshall refers to the fact that "the great body of the shareholders of a joint-stock company are . . . almost powerless" and adds, "It is a strong proof of the marvelous growth in recent times of a spirit of honesty and uprightness in commercial matters, that the leading officers of great public companies yield as little as they do to the vast temptations to fraud which lie in their way." — *Principles of Economics*, 8th ed. (London: Macmillan & Co. Ltd., 1925), p. 303. John Stuart Mill wrote half a century earlier, "The administration of a joint stock association is, in the main, administration by hired servants, . . . the business being the principal concern of no one except those who are hired to carry it on. But experience shows, . . . how inferior is the quality of hired servants, compared with the ministration of those personally interested in the work . . ." — *op cit.*, I, 136.

[16] Berle and Means, *op cit.*, pp. 125, 349.

[17] See, e.g., James Burnham, *The Managerial Revolution* (New York: The John Day Company, Inc., 1941), and recently, from the communist side, Milovan Djilas, *The New Class: An Analysis of the Communist System* (New York: Frederick A. Praeger, Inc., 1957).

enterprises in which ownership and control are still in the same hands Perhaps even more characteristic than the existence of a few hundred big corporations is the fact that the freedom of the capitalist system leads to a great diversity of industrial units This diversity makes it more likely ' in every unexpected contingency, that somewhere there will be found a type of institution best fitted to master the new conditions Industrial diversity offers a better chance that somewhere and somehow the ideas of innovators will at least be given a trial and provided with the facilities for development " [18]

We could list this fact separately in an enumeration of economic freedoms under capitalism that the forms and sizes of private enterprise are adjustable to their tasks and thus provide a flexibility which bureaucratic systems may not be able to match

The Freedom to Save and Invest

The freedom to save is already included in the free choice of consumption, since it simply amounts to the freedom to choose between consumption now and consumption in the future Saving can be defined as not-consuming The decrease in present consumption is a sacrifice made for the enjoyment of future consumption In capitalism the right to save is supported and enhanced by the right to bequeath wealth, so that the choice between present and future consumption is not limited to the adult life of one person The right to bequeath (or to inherit) cannot be granted too readily in economic systems which aim at government ownership of the material means of production The accumulation of savings means the accumulation of wealth which will have to consist, directly or indirectly, in claims on income from the ownership of the material resources of the nation. The freedom to save, to inherit, and to accumulate wealth is therefore a right which is even more peculiar for capitalism than is the free choice of consumption and of occupation

The freedom to invest is implied in the unplanned character of the capitalist economy By investment we mean the purchase or production of new capital goods by business firms These firms are under no obligation to invest We cannot be sure, therefore, that the production of investment goods will always correspond to intended savings during any period In our model of the free market economy we assumed that the rates of interest would be just high enough to bring about an equality between saving and investment In this case unemployment and deflation will be avoided But if money has been earned as income and is spent neither on consumers' nor on capital goods, the result will be a decline in employment and na-

[18] Cf John Jewkes contribution to *Problems of United States Economic Development* (New York Committee for Economic Development, 1958), I, 263

tional income. Such a discrepancy is possible in an unplanned economy. It is possible because of the freedom to consume, to save, and to invest and because of the fact that those who save are, as a rule, a different group from those who invest. True, the market is supposed to bring saving and investment into balance, but under certain circumstances it may fail to do so. Then it is the task of the government to see to it that a sufficient amount of spending is maintained. We shall see how this task is accomplished through monetary and fiscal policies within the framework of the capitalist economy.[19]

In its attempt to maintain a sufficient amount of spending, the government may overshoot its aim and let inflationary pressures develop. But inflation certainly has not been exclusively only a capitalist sin; as we shall see, all social economic systems seem to be guilty of it.

Competition and Monopoly

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Our model of the free market economy was a competitive model; it had to be, because a sufficient amount of competition is indispensable if the whole production and distribution process is to be regulated by market forces. This same thought, more than a hundred years ago, made John Stuart Mill say that "only through the principle of competition has political economy any pretension to the character of a science."[20]

Competition is necessary in a capitalist economy to keep initiative constantly on the alert, to protect the consumer against exploitation, and to maintain a sufficiently flexible price system. Nevertheless, monopolistic tendencies are an intrinsic feature of the capitalist economy. They are the outgrowth of the consistent and unrelenting application of the profit motive by the private economies; it is indeed because competition keeps the acquisitive tendencies in check that it is eliminated wherever feasible.

Where the producing units are small and numerous, a monopolistic position cannot be achieved; but where the average size of the producing units has grown very large and where only a few firms constitute the whole industry, competition has become more limited. It has been argued that in this situation monopolistic tendencies can be defended as a legitimate reduction of the risk implied in the investment of the enormous amounts of capital that form the productive apparatus of modern large-scale production. We shall examine these claims in Chapter 7. At present it suffices to state that monopolistic tendencies are inherent in modern capitalism, but that they are, at the same time, a negation of its basic philosophy, according to which no private agent should be strong enough to rig the market. Some of the most ardent defenders of the free market system therefore have

[19] See Chapter 9, below.
[20] Mill, *op. cit.*, I, 235.

emphasized that it may be necessary for the government to plan for com petition '[21]

In our discussion of the free market economy, we saw that each member of the economy trades on two markets (as consumer and producer) and that on each market buyers as well as sellers fight on two fronts against the person with whom they are bargaining and against their competitors If much competition exists on one side of the market (e g among employees) but not on the other side (among employers) the chances are that the side with the lesser competition gains the advantage in bargaining This fact, which was already clearly stated by Adam Smith[22] has recently been em phasized in John Kenneth Galbraith s theory of countervailing power[23] Galbraith suggests that capitalism can work reasonably well in spite of its monopolistic tendencies since new restraints have in part taken the place of the restraints imposed by competition These restraints do not appear on the same side of the market but on the opposite side Thus the employers who according to Adam Smith can so easily band together are faced with a contrary defensive combination of workmen [24] Similarly, the suppliers of consumers goods may meet a consumers cooperative on the other side or a food chain or mail order houses Galbraith does not claim that countervailing power is always effective and he states expressly that it fails to work in times of inflation But his theory suggests that the government can maintain a reasonable balance in the market place not only by breaking up monopolies but also by strengthening countervailing against original power

If we want to express these thoughts in terms of economic freedom com petition can be described as the right to or the possibility of free entry into a market and countervailing power as the freedom of association

Capitalism and Productivity

To compare the productivity of different economic systems is an important task of comparative economic analysis But it is also perhaps the most exas perating of such tasks The difficulty is that a country s economic system is only one of many factors which determine the size of the country s real per capita income growth rate and other measures of productivity We can compare either the economy of different countries during the same period or

[21] See e g F A Hayek *The Road to Serfdom* (Chicago The University of Chicago Press 1944) Henry C Simons *Economic Policy for a Free Society* (Chicago The University of Chicago Press 1948)
[22] Adam Smith *The Wealth of Nations* (London Methuen & Company Ltd 1925) Vol I Book 1 Chap 8
[23] John Kenneth Galbraith *American Capitalism The Concept of Countervailing Power* (Boston Houghton Mifflin Company 1952) Chap 9 10
[24] Smith *op cit* I 69

the economy of one country at different periods; but we cannot carry through a controlled experiment, changing the economic system but keeping all the other data constant. Thus, even if we are able to show that capitalism has performed rather well in the United States during the last hundred years, we may not be able to impress others with our figures, because they will argue that their chosen system would have performed even better under such favorable circumstances.

Karl Marx was fully aware of the tremendous productive power of capitalism. In *The Communist Manifesto* we read:

> The bourgeoisie during its rule of scarce one hundred years, has created more massive and more colossal productive forces than all preceding generations together. Subjection of Nature's forces to man, machinery, application of chemistry to industry and agriculture, steam-navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalization of rivers, whole populations conjured out of the ground—what earlier century had even a presentiment that such productive forces slumbered in the lap of social labor? [25]

Yet we know that Marx was convinced that a socialist society would be *infinitely more* productive because it would remove capitalism's "antagonistic conditions of distribution," which create an increasing discrepancy between consumption and production. We see that we could not impress a Marxist with figures of which we think we can be justly proud.

The enormous impact which the news of Russia's launching of the first satellite had on the Western world indicates that the event exploded a cherished myth about the inefficiency of bureaucracy. The question is no longer whether a bureaucracy can technically do what we can do; it is only one of cost, both in resources and in freedom. There is no doubt that capitalist countries can match totalitarian nations if they are willing to pay the price. The price may even be lower in terms of the necessary reduction in consumers' goods production. But the question is whether even this lower sacrifice can be extracted in a free system under conditions of peace.

The astonishing thing about capitalism's performance is its haphazard nature, the fact that nobody planned it, that this enormously productive system simply grew and that it achieved its results under conditions of unparalleled freedom. It is not surprising, then, that capitalism's productivity was ascribed exactly to its unplanned nature and to the twin forces of profit motive and competition.

Without suggesting that this explanation is wrong, it ought to be pointed out that capitalism's technical progress is not always the strongest where competition is found in its purest form. On the contrary, we can come to

[25] Karl Marx, *Capital, The Communist Manifesto and Other Writings*, ed. Max Eastman (New York: The Modern Library, Inc., 1932), p. 326.

the conclusion ' that there must be some element of monopoly in an industry if it is to be progressive "[26] This need arises from the high cost of developing new products and the fact that a firm which is not sufficiently protected (through an element of monopoly) has no incentive to undertake large research and development expenditures if the results can be copied at much less cost by its competitors If, then, development is to a great extent concentrated in the big corporations, we approach again the territory in which, to some observers, the differences between the various economic systems tend to disappear

The Role of Government in the Capitalist Economy

Even our model of the free market economy was supposed to have a public sector in which are satisfied collective wants which cannot be met by private producers Where it is impossible to charge a price, a portion of the national income must be collected in the form of taxes to pay for public services In addition, government agencies may be substituted for private business units where the technical nature of the production processes favors government ownership or where the danger of monopolistic exploitation becomes too great Substitution of this sort is especially suitable for so-called octopoid industries which, like transport, gas and electricity, the telegraph and telephone, ' are those involving the use of large and widely ramifying plant, which it would clearly be wasteful and inconvenient to duplicate, and whose installation, since it involves interference with public or private property, calls in any case for some intervention on the part of the State "[27] It is obvious that a substantial amount of public ownership can exist without violating basically the capitalist nature of an economy

The government influences the private sector of the economy through its tax system A completely "neutral ' tax system cannot exist Taxes will always affect income distribution, demand, costs, and production The government therefore cannot evade using its revenue collection to further its economic policies, whatever they may be But if the capitalist system is to be maintained, the tax structure must be so chosen that it does not destroy the basic features of capitalism Incomes cannot be made entirely equal, because this would destroy the allocation process of the market, saving must be encouraged if a sufficient amount of capital accumulation is to take place, and private initiative must not be smothered by excessive taxation if the motive power of the free system is to function

We have already referred to the need for a regulation of competition and monopoly Such government regulations express themselves today in antitrust legislation, encouragements and limitations of collective bargaining,

[26] Galbraith, *op cit* p 93
[27] Robertson *op cit*, p 114

commercial policies, agricultural policies, the regulation of public utilities, credit policies, etc. It need hardly be pointed out that these regulations are not always applied in a consistent manner; for example, some of them try to plan for competition at home, whereas others exclude foreign competition.

In very general terms it may be stated that regulation of private economic activity in capitalism should be indirect rather than direct and should support the forces of the market rather than interfere with them. The most important policies of the indirect type are monetary and fiscal. Monetary policy has the task of keeping money neutral in the sense that the relative price structure is not changed by a contraction or undue expansion of the monetary circulation. While it may seem obvious that monetary policy ought to avoid both deflation and inflation, experience has shown that we deal here with difficult theoretical issues and even more difficult practical problems.[28]

Monetary policy can set limits within which sellers can succeed in raising the prices of their goods and services. If labor then bargains for wages in excess of what the increase in efficiency seems to justify, unemployment will result. Great pressure will then be exerted to make the monetary authority give way. Increasing the monetary circulation under these conditions can permit a higher employment level at the expense of higher product prices. Such a situation is called creeping inflation, which can be dangerous when it leads to overinvestment. Who is then to blame—the monetary authority, because it was not firm enough, or those who created a situation which did not permit a high employment level without price inflation?

Monetary policy can play an active part in antirecession policies by lowering the price of borrowing in an attempt to stimulate both investment and consumption. When this stimulation proves insufficient, government deficit spending may have to be employed. Deficit spending implies a cooperation between fiscal and monetary authorities, because public agencies are now to undertake expenditures in addition to those already scheduled to be financed from taxation and sale of government securities to the saving public. It goes without saying that deficit spending need not be inflationary provided unemployed resources are brought back into production so that an increase in demand is met by increased supply.

Since the capitalist market process does not always lead to equilibrium at full employment, monetary and fiscal policies have an important role to play. The weapons used are powerful and dangerous, however, and, wrongly used, may do more harm than good. We shall have to deal with these problems in Chapter 9.

In this connection it should be emphasized that the deep depression of the early thirties, which did so much to harm capitalism's reputation, was

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28 Cf. George N. Halm, *Economics of Money and Banking* (Homewood, Ill.: Richard D. Irwin, Inc., 1956), Chaps. 12, 24.

caused oot so much by an inherent weakness of the pricing process as by public policies which first tempted the economy into nverexpansion and then forced it into a completely unnecessary cnntraction We may be reasonably confident that these mistakes will not be repeated to the same extent and that capitalism will be given a better chance to show hnw well it can perform, now that its working principles are better understood by the policy makers

One type of policies can be exposed as clearly contradicting the basic principles of the capitalist system, these are the policies designed to secure for different groups a fixed portion of the national incnme The income distribution is part and parcel of the whole pricing process, and to guarantee past returns under changing conditions—to freeze a given pattern of distribution—means to destroy the allocation process on which the free econ omy has to rest When ooe group is guaranteed absolute security, it enjoys the advantage at the cost of greater insecurity for the rest When all groups are to be given complete and proportionate income security, the scheme becomes absurd—just as one caooot escape the evils of inflation by putting everybody's income on a sliding scale

These remarks, bowever, argue in no way against the necessity of offering to everybody a minimum of social security

Some social aims cannot be reached within the framework of capitalism When we insist on these aims, we have to reconstruct the whole economic system on entirely different principles If we do so, we may not be able to retain the essence of a free economy which lies in the ackoowledgement that "there is a circle around every individual human being, which no government, be it that of one, of a few, or of many, ought to overstep "[29]

Four Attacks on Capitalism

We have seen that objective standards for the evaluation of a social-economic system are impossible to find Nevertheless, we shall attempt a discussion of the most serious criticisms which have been used to discredit capitalism The following five chapters, which try to undertake this difficult task, are, however, oot meant to indicate that capitalism is mainly char acterized by defects and that nothing much can be said in its favor These chapters will serve equally to defend the free market system where the attacks seem to have gone too far

The attacks on capitalism are essentially four

(1) The oldest attack aims at the unequal distribution of wealth and income and the fact that such inequality leads to inequality in economic and political power as well

(2) Capitalism is often considered less productive than collectivist sys-

[29] Mill *op cit*, II, 443-444

tems which can consciously plan for development. In particular, it is argued that profitability is not identical with productivity and that competition is often excessive.

(3) At the same time, capitalism is, in the opinion of many observers, not competitive enough. The profit motive and the competitive struggle, together with modern technology, lead to monopolistic tendencies which seem to violate the very philosophy of capitalism. In this criticism, therefore, socialists and the proponents of the free market economy join their forces, though they disagree on the proper remedies.

(4) Capitalism does not always maintain a high level of employment. In a depression, productive resources are wasted and the national income is kept below a potential maximum. Apart from this loss in productivity, prolonged mass unemployment is one of the most dangerous social diseases to which an economic system can be exposed.

In discussing these criticisms we must remember that no economic system can accomplish everything—that every economic system must be a compromise. All we can try to do is to disentangle the aims, demands, claims, and criticisms and to show what capitalism can be expected to achieve on the basis of its inherent logic.

We must be particularly careful when capitalism's deficiencies are to be corrected at the price of the freedoms which are the most characteristic feature of the market economy. We ought not to forget that capitalism has proved its compatibility with political democracy, whereas all centrally planned systems, so far, have been totalitarian. Will it be possible to maintain economic and political freedom when we aim for goals which capitalism admittedly cannot reach?

CHAPTER 5

CAPITALISM AND INCOME DISTRIBUTION

Functional and Personal Distribution

We have seen how the pricing process of a free market economy takes care of the problem of distribution The prices that are paid for the use of the factors of production become the income of the owners of the factors, and since the factors are privately owned, the national income is automatically distributed

This identity of the pricing and income-distribution processes in capitalism has been the cause of some misconceptions In order to eliminate these misconceptions, we must try to disentangle two distribution concepts personal and functional distribution

Many classical economists failed to see how the personal distribution of income could possibly differ from the functional distribution The factor prices which created equilibrium between demand and supply were the "natural" prices, and incomes derived from these prices were considered "just" Moreover, these prices performed the function of allocating the factors, of guiding them into the right industries The factor owners' self-interest could be relied upon, command or general plan was unnecessary Indeed, within the framework of the capitalist economy there was no point in trying to disentangle what was practically one and the same thing the functional and the personal distribution Any attempt to divorce the two would have changed the basic structure of the capitalist system

But there was one flaw in this arrangement The resulting income distribution was very unequal—so unequal, indeed, that what capitalist writers had called just seemed to socialist critics of capitalism to be most unjust The socialists accordingly aimed at a system with a more equal personal distribution, but they failed to see all the implications of their aim They often assumed, for instance, that once the government had acquired owner-

ship of the material factors of production, payment of interest and rent would no longer be necessary. Interest and rent could be abolished and the social product be distributed among the laboring class, though certain deductions for purposes of accumulation (i.e., capital formation) would have to be made.

Their preoccupation with the problem of personal distribution prevented these writers from seeing the allocation problem. Scarce factors like capital and land must have prices which reflect the exact degree of their scarcity if there is to be a rational distribution of available factors among different industries. This allocation is the essence of the functional distribution problem. It is, theoretically, independent of the question of who should receive this factor price as personal income.

Had it been clear to the critics of capitalism that this functional distribution or allocation process is essential, they would also have seen that changes in the personal distribution can have far-reaching consequences. They would have seen, for instance, that a bureaucratic system of accounting would have to replace the capitalist pricing process, that *all* scarce factors (and not only human labor) would have to be accounted for, and that equal wage rates would not properly distribute labor among different industries.

Failure to distinguish between personal and functional distribution explains Karl Marx's labor theory of value, a theory designed to prove that the value of commodities is exclusively determined by the social labor necessary to produce these commodities.[1] Marx's effort was unnecessary. He could have accepted the idea that all scarce factors (and not only labor) must be included in the general economic accounting process without having to accept the particular personal income distribution which is characteristic of capitalism.

The concept of personal income distribution, which is readily understood, concerns the shares of the national income which go to the individual members of the economy. The concept of functional distribution is more difficult to grasp. By functional distribution we mean the shares of the national income which are imputed to the factors of production according to their relative scarcities. These latter shares may or may not be paid to individual human beings. They may, for instance, go to the government if the government has nationalized the material factors of the production. It is important that we see that this accounting in terms of factor values is indispensable in an economic system that wants to make the most economical use of its productive resources in the achievement of its aims.[2]

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[1] See Part III, below.

[2] The share of the national income which can be considered the contribution of a given factor of production (in the functional distribution process) is determined by the equilibrium price of one service unit (e.g., an hour of labor) times the total supply of these services during the income period. In terms of the Casselian equations, discussed in the Appendix to Chapter 3, these shares are $R_1q_1, R_2q_2, \cdots R_rq_r$.

Personal and functional distribution are very closely related in capitalism because *the factors of production are privately* owned (government ownership being the exception from the rule) The individual members of the capitalist society receive, as their private income, whatever the market pays for the use of the factors which these members happen to own The resulting personal income distribution thus depends on (1) the factor prices, which are determined on factor markets according to the relative scarcity of each factor, and (2) the distribution of factor ownership among members of the economy

Even if private property in the material factors of production were abolished, differences in personal income distribution would remain, owing to the greater scarcity of one kind of labor compared with another It can also be seen that personal income in a market economy must be exposed to constant variations as changing demand and supply make the various factors relatively more or less scarce

Suppose that we wanted to equalize the income from labor Wage differentials would then be eliminated, at least in the process of personal distribution It would then still be possible for the government to maintain wage differentials in its acconnting procedures [8] But this separation of personal and functional distribution would mean that labor would no longer be automatically pulled in the right direction, because the elimination of wage differentials has simultaneously elimminated the inducement on which the allocation of labor rests in the free market economy Labor must now be moved by command i e , the free choice of occupation must be dispensed with This allocation by command is not very practical But it will be observed that the maintenance of wage differentials in the government s accounting processes would, at least, tell those in command where a given kind of labor should be used

Let us assume that the functional distribution is also the personal distribution in the case of labor, i e , that various kinds of labor are paid according to their scarcity Could we, nevertheless, achieve a much more equal income distribution through nationalization of the material factors? Again we could maintain the functional distribution process intact, i e , we could establish prices for the material factors according to their relative scarcity, and the resulting interest, rent, and profit would be paid to their new owner, the government The government might decide to distribute as a ' social dividend ' all or part of its functional share in the national income In such an event the government must be extremely careful not to upset the functional distribution on the labor market If the government seeks to compensate those receiving low incomes from labor by giving them a relatively large social dividend (and vice versa), the allocation

[8] See Chapter 17, below

process of the labor market will be destroyed just as certainly as it would have been by directly equalizing income from labor.

Again we have seen that it is difficult to disentangle the personal and functional distribution processes. A social economy with government ownership of the material means of production, but with free choice of occupation, would be rather limited in its attempts to equalize personal income. A dictator could possibly allocate labor by command alone and bring about whatever personal distribution of income he desires. But even he is likely not to dispense with the inducements which are implied in a partial connection of personal and functional distribution on the labor market. We shall see, furthermore, that a consistent functional distribution of income is a "must" in every social economy, including the dictator's, which wants to act rationally.

The Critique of Inequality

The economist can criticize the inequality of income distribution on the grounds that it eliminates the possibility of satisfying wants in the order of their importance.

Abba P. Lerner argues that "total satisfaction is maximized by that division of income which equalizes the marginal utilities of the incomes of all individuals in the society."[4] This follows from the principle of diminishing marginal utility, which asserts that "the amount of satisfaction that every individual obtains from his income depends upon the size of his income in such a manner that he always gets more satisfaction from a larger income, *and that the extra satisfaction he gets from a given increase in his income* (the marginal utility of income) *is less if his original income is greater.*"[5]

It is true, of course, that we cannot compare the marginal utilities of the incomes of two individuals, even if the incomes are identical. Nevertheless, unequal income distribution means unequal chances for the satisfaction of individual wants. We cannot argue that the rich are, by and large, more cultured than the poor and that their higher incomes correspond, therefore, to more refined, diversified, and numerous wants. A positive correlation of income and power of enjoyment may well exist in individual cases. If it is used to defend an unequal income distribution, however, we can argue that (1) "a man with a high income gets used to the luxuries he can afford so that he consumes them almost automatically, hardly noticing that he does so and so getting practically no enjoyment out of what would give

[4] Abba P. Lerner, *The Economics of Control* (New York: The Macmillan Company, 1946), p. 28. Copyright 1944 by The Macmillan Company, and used with their permission.

[5] *Ibid.*, p. 26.

a great thrill to the poor man unused to these expenditures", (2) the lower incomes are, the more urgent are the wants which are satisfied by spending the marginal dollar, and (3) in the long run different individuals' capacities for *acquiring* the power of enjoying income can be put in the place of *the actual* capacity for satisfaction "[6]

These same ideas have often been expressed through examples which showed that luxuries are produced when large parts of the population lack the necessities of life George Bernard Shaw, for instance, calls a nation "that spends money on champagne before it has provided enough milk for its babies a badly managed, silly, vain, stupid, ignorant nation' and, he adds, "the only way in which a nation can make itself wealthy and prosperous is by good housekeeping that is, by providing for its wants in the order of their importance, and allowing no money to be wasted on whims and luxuries until necessities have been thoroughly served "[7] Many similar passages could be quoted both from socialist and capitalist writers It seems to be a common opinion that the capitalist economy does not maximize total satisfaction This opinion is not just another value judgment but rests on the application to the economy as a whole, of principles which are considered sound economics for every individual economy

That most people share, at least unconsciously, this criticism of income distribution is revealed by the fact that the principles which govern the satisfaction of individual wants in the private sector of the economy are not allowed to be applied to the public sector Because the individual economies have to pay indirectly, through taxation, for the satisfaction of collective wants, they have to curtail the satisfaction of private wants But how are we to fit the saisfaction of collective wants into private household plans which differ as widely as do the individual incomes on which they are based?

The solution of this problem is basically quite obvious The satisfaction of collective wants concerns all individual households, whereas each of these individual households reaches a different degree of satisfaction of private wants It is necessary, therefore, to adjust compulsory tax contributions in such a manner that the poor pay little or nothing and the rich not only a proportionally but rather a progressively larger share of their incomes as taxes Certainly, we would consider it absurd if it were suggested that each person contribute exactly the same amount, the poor family of five members therefore five times as much as the rich bachelor However, this very same principle is applied to the satisfaction of private wants In the private sector of the economy, the poor pay, indeed, just as much for the necessities of life as do the rich

To emphasize these important considerations, we reiterate the following points

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[6] *Ibid*, pp 34, 35

[7] G Bernard Shaw, *The Intelligent Woman's Guide to Socialism and Capitalism* (New York Brentano s, 1928), pp 50-55

(1) Only *within* the individual consuming unit is an attempt made to fulfill the "economic principle" of allocating the available means to the satisfaction of wants in the order of the latter's importance.

(2) The unequal distribution of income and the market price system prevent such a maximum satisfaction from being aimed at, let alone achieved, for the private sector of the economy *as a whole.*

(3) The distribution problem must be faced in the public sector of the economy, where the satisfaction of collective wants requires an indirect method of financing.

(4) This method of financing the satisfaction of collective wants is radically different from the way in which consumption is paid for in the private sector of the economy.

(5) To tax the rich more than the poor is considered necessary in order to fit the satisfaction of collective wants into the household budget of people of different means.

(6) General acceptance of modern tax systems implies a criticism of the way in which the national product is distributed in the private sector of the economy.

The same criticism is even more obviously implied in the fact that, in times of war, price controls and rationing have become generally accepted practice in all capitalist countries. As soon as a sudden and unusual scarcity of important consumers' goods leads to sharp increases in price, it is considered necessary to replace commodity distribution via market prices with an allocation which is based on entirely different principles. The sudden accentuation of a shortage makes us realize that our method of distribution in capitalism is not at all equalitarian. Then, and because of a generally different attitude to such problems in times of war, we are willing to introduce controls which are alien to the basic principles of the capitalist society. That they are alien is shown not only by the partial abolition of free choice of consumption. More important and characteristic is the fact that these controls, first introduced in relatively few markets, tend to multiply as if by chain reaction. Selective rationing will have to include more and more articles because the purchasing power released through price control and rationing shifts to unrationed markets which, in turn, through higher prices, attract the factors of production. Producers are tempted to leave the fields under price control and rationing, thus increasing the very scarcities which brought about the controls. Consequently, an ever-increasing number of industries must be brought under price and production controls.

Rationing and price controls teach two interesting lessons. They bring to light a rather widespread disapproval of the present system of distribution; and they demonstrate, in their effect upon the economy, how fundamentally any such change in the distribution process affects the whole capitalist economy.

Income Distribution and Saving

The more unequal the distribution of income, the higher will be the rate of saving, other things remaining equal "The fundamental psychological law, upon which we are entitled to depend with great confidence both *a priori* from our knowledge of human nature and from the detailed facts of experience, is that men are disposed, as a rule and on the average, to increase their consumption as their income increases, but not by as much as the increase in their income "[8] In other words, men are apt to save a larger proportion of their income as they grow richer and a smaller proportion of their income as they become poorer

Here we come to an argument which is often used in the defense of the inequality of income distribution in capitalism Receivers of large incomes, we are told, spend only a small fraction of these incomes on consumption The rest is saved and invested. Investment, the production of capital goods, increases the productivity of the economy and therefore the income that can be distributed If the rich would not save, the function of capital accumulation would have to be fulfilled by the government through taxation Unequal income distribution therefore leads, in the long run, to higher incomes all around, while equal income distribution would only insignificantly increase the incomes in the lower brackets,[9] The distribution, finally, of what the rich actually consume would allow only a negligible expansion of the consumption of the lower income classes

There should be general agreement that a substantial and continued increase in real wages cannot be brought about by redistribution alone The decisive factor is the increase in productivity, which depends on capital formation Questions of distribution (which remain important, if only for psychological reasons) must therefore be discussed from the point of view of the effect which measures aimed at the redistribution of the national income have on the size of the national income

Since capital formation is absolutely essential for the growth of an economy, it is obvious that consumption must be restricted, either through private or public saving The economic growth of the Soviet economy at *the expense of a very low consumption level* illustrates the case in point

Where private saving is responsible for capital formation, greater inequality of income distribution tends to lead to greater savings, while

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[8] John Maynard Keynes *The General Theory of Employment Interest and Money* (London Macmillan & Co Ltd, 1936), p. 96

[9] Carl Snyder estimated that the net annual savings for reproductive capital in the United States during the period of the 1920s (of not more than three to four billion dollars per annum), if diverted to augment the incomes of the fifty million gainfully employed would have amounted to only sixty dollars per person per year, five dollars per person per month.—Carl Snyder, *Capitalism the Creator* (New York The Macmillan Company, 1940), p 143

greater equality could dangerously decrease the supply of loanable funds. But the savings argument, as stated above, does not contain all we need to know. Saving is not in itself virtuous, nor is its effect upon the economy necessarily favorable.

N. W. Senior claimed in his famous theory of "abstinence" that interest payments are "earned" much in the same way as wages. Carl Snyder answered the question of "who created the gigantic industrial apparatus of modern capitalism" to the effect that "in a sense, 'labor' contributed almost nothing," and that it was capital savings alone "which has alike created this wondrous industry, and all the modern world of comfort, convenience, and luxury besides." [10]

These statements are hardly correct and fair. Interest is not paid according to the amount of abstinence implied in a given amount of saving. Furthermore, the receivers of small incomes, who work hard and consume little, do as much to set means of production free for investment purposes as do the receivers of high incomes. It is the latter, however, who determine the rate of capital accumulation and not those whose present consumption is not yet adequate.

Capital accumulation in capitalism is a matter of chance. Nobody can be praised or blamed for it, because saving is an act which is completely devoid of any intentions concerning the economy as a whole. Anyhow, whether the amount of savings which is forthcoming at a given level of the national income is too much or too little cannot be decided on a priori grounds. Until recently it was generally assumed that oversaving was impossible because of the regulating effect of the rate of interest and the permanent availability of untapped investment opportunities. In Chapter 8 we shall see that these assumptions are not always safe. If profitable investment opportunities are lacking, the tendency to save more than can be readily invested will lead only to contraction and unemployment. In this case a more equal income distribution, with the consequence of more consumption and less saving, could help to maintain a higher income level. However, we must not draw the conclusion that saving is bad and that a more equal income distribution (which decreases saving) is always advisable. Generalizing statements of this sort are not permissible. Whether the effect of a more equalitarian distribution upon the size of the national income is favorable or unfavorable depends entirely on the circumstances.[11]

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[10] N. W. Senior, *Outline of the Science of Political Economy* (London, 1836); Snyder, *op. cit.*, p .4.

[11] "If in the long run it appears that we face a problem of 'oversaving,' the cure is an onslaught, not against savings, but against the institutional obstacles to investment. As long as the material welfare of the lower income groups leaves much to be desired, as long as vast quantities of capital can be used for slum clearance, hospitals, schools, etc., for the benefit of the broad masses of people, it is a cruel myth that we have 'too much saving. To remedy unemployment arising from uninvested saving by attacking saving is analogous to reducing mortality from diabetes through lowering the birth rate."—Howard S. Ellis, "Economic Expansion through Competitive Markets,"

Taxation, Government Expenditures, and Distribution

A major attack upon excessive inequality is to be found in the tendency of the public sector of the economy to grow relative to the private sector This works as a two pronged drive

(1) The indirect way of financing public expenditures through taxation permits, as we have seen, the preferential treatment of the lower income groups and the imposition of a heavier burden upon the rich, through death duties, steeply progressive income taxes, differentiation of earned and unearned income, etc

(2) The government satisfies collective wants, and in this satisfaction the poor and the rich share alike Of the many services the government can render, the provision of educational opportunities is of paramount importance in connection with the problem of income distribution

As inequalities in income distribution mean inequalities in educational opportunities, they tend to perpetuate themselves to some extent High income, invested in the development of special skills through higher education creates more earning power, which in turn leads to higher income out of which expensive training for the children in higher income groups can be paid Poverty, on the other hand, deprives the children of the poor of proper educational opportunities, weakens their earning power, and so tends to perpetuate itself

According to A C Pigou, these considerations constitute a powerful argument for *some sort* of change aimed at increased equality [12] They also show how we can get at the very root of the problem and still maintain a free market economy A determined effort can be made to free educational opportunity as far as possible from limitations imposed by uneven distribution of income [13] But free education alone does not solve the problem, as long as those who are eager to enjoy the advantages of higher learning cannot be maintained out of private means during the training period

Educational reforms (through their long run effect on the national product) are a good example of the fact that the government's efforts toward

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in *Financing American Prosperity* P T Homan and F Machlup, eds (New York The Twentieth Century Fund 1945) p 133

[12] A C Pigou *Socialism versus Capitalism* (London Macmillan & Co Ltd., 1937) p 22

[13] "*There is no extravagance more prejudicial to the growth of* national wealth than that wasteful negligence which allows genius that happens to be born of lowly parentage to expend itself in lowly work No change would conduce so much to a rapid increase of material wealth as an improvement in our schools and especially those of the middle grades provided it is combined with an extensive system of scholarships, which will enable the clever son of a working man to rise gradually from school to school till he has the best theoretical and practical education which the age can give" —Alfred Marshall *Principles of Economics* 8th ed (London Macmillan & Co Ltd, 1925), p 212

greater equality need not always take from the rich what they give to the poor. If this were so, if the public sector were as parasitic as some writers want us to believe, production would cease altogether once the public sector has devoured the private sector, as in Russia today. Actually, government policies can help maintain and even increase the income stream, and some of these policies may, in rare cases, operate through the maintenance of a high consumption level via a more equal income distribution. It is not always necessary for the government to take in order to give, just as higher wages need not always be taken out of profits, or as one country's gains in international trade are possible without a corresponding loss by other countries.

That there are limits to progressive taxation is quite obvious. When the receiver of a very high income has to earn £200 to be permitted to retain £5, a condition that exists in England at present for the highest income group, the incentive to try to increase his income is weakened to the vanishing point. Leisure must be considered cheap under these conditions, risk taking is discouraged, and even the proper division of labor will not be maintained, as James Meade has convincingly shown.[14] If a man has to earn £200 to be able to pay £5 to have a certain piece of work done, he may well decide to do the work himself, because only if he is forty times more productive in his special job will it be profitable for him to hire help.

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[14] James Edward Meade, *Planning and the Price Mechanism* (London: George Allen & Unwin, Ltd., 1948), p. 40.

CHAPTER 6

CAPITALISM AND PRODUCTIVITY

Introduction

In the preceding chapter we had to arrive at the conclusion that the distribution of the national income cannot be radically changed if we want to maintain a private enterprise system This conclusion shifts our argument to the question of how large a product can be distributed, how productive the system is Assuming a given distribution pattern, the absolute size of the personal shares will depend on how large a social product the economy is able to produce

The two main criticisms of the capitalist system on the grounds of insufficient productivity concern the monopolistic character of capitalist industry and the recurrence, at least in the past, of periods of unemployment We shall discuss these problems in the three chapters which follow First, however, we shall examine several socialist arguments that capitalism would not be as productive as socialism even if it were sufficiently competitive and free from cyclical fluctuations Socialists would still maintain that *the inequality of income distribution in* capitalism checks the *inherent* productive powers of the system because of deficiencies in demand, that profitability does not guarantee productivity, and that socialism could produce a larger social product than even full employment capitalism

Inadequacy of Demand?

The theory of underconsumption is an old stand by of the critics of capitalism, though few modern socialists would support this theory in its naïve formulations Modern economists admit, as a rule, that increasing purchasing power as such is not a panacea which would open the doors to a

fool's paradise in which, after the removal of all scarcities, economic problems would cease to exist. Innumerable proposals have been made for reaching the land of plenty through an increase in purchasing power. Usually the proposals have rested on fantastic assumptions about what modern industry could produce, provided the products could be marketed.

The underconsumption theory assumes either that the exploitation of wage earners creates a chronic deficiency in demand or that saving increases production and reduces consumption simultaneously.

The simple underconsumption theory, according to which "the working class receive too small a portion of their own product, and the evil would be remedied by giving them a larger share of it, or raising their wages," was rejected by Karl Marx, who pointed out that "crises are precisely always preceded by a period in which wages rise generally."[1] The trouble is that if wages are increased in order to increase the purchasing power of the masses "this rise in demand merely offsets the rise in cost of production due to higher wages. A larger expenditure of money is now needed to buy the same goods, and the increase in money income is not an increase in real purchasing power."[2] The result would be price inflation.

The theory that saving is dangerous because it increases the supply of consumers' goods at the very time it decreases consumers' demand is easily refuted. When savings are actually invested, i.e., when capital goods are produced, the productivity of the economy increases and more consumers' goods are eventually supplied. But there is no inherent necessity for consumers' demand to be deficient at any time. The decrease in consumption, owing to saving, and the increase in consumers' goods output, as a result of increased investment, are not simultaneous. It takes time to produce machinery and, with the machinery, consumers' goods. The decreased consumption will at first be counterbalanced by an increased demand for investment goods; and when higher productive efficiency lowers the unit cost of production and the price of the products, purchasing power is released for the absorption of additional consumers' goods.[3]

With this criticism we do not mean to deny that the capitalist economy can be exposed to a dangerous inadequacy of demand because of insufficient profitable investment opportunities or faulty monetary policies. We shall return to these problems in Chapter 8.

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1 Karl Marx, *Capital, A Critique of Political Economy* (Chicago: Charles H. Kerr & Company, 1933), II, 476.

2 Joan Robinson, *Introduction to the Theory of Employment* (London: Macmillan & Co. Ltd., 1938), p. 50.

3 For the most famous modern version of the underconsumption theory, see W. T. Foster and W. Catchings, *Profits* (Boston: Houghton Mifflin Company, 1925). For a critique of Foster and Catchings, see A. H. Hansen, *Business Cycle Theory* (Boston: Ginn & Company, 1927), and F. A. Hayek, *Profits, Interest and Investment* (London: Routledge & Company, 1939).

Technocratic Utopia

Even a full employment economy of the capitalist type would, in the opinion of many socialists, remain far below the level of productivity which a socialist economy could achieve

> In the capitalist economy, production is carried on not for the purpose of increasing commodity supply but for the purpose of increasing entrepreneurial wealth Not the highest productivity for the social economy but the highest profitability for the individual economy is the final aim of production The mightiest machine which can be created in the capitalist era is, therefore, the machine which satisfies existing demand but never the infinitely more powerful machinery which satisfies *absolute* demand [4]

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This quotation is characteristic of a group of writers who tended to over estimate the productive power of the modern industrial system to a fantastic degree The group included such men as Bebel, Ballod, Hertzka, Tugan Baranovsky, and the members of the technocratic movement in the United S ates These socialists and technocrats asserted that our technical knowledge would enable us to produce a much higher national product with a much smaller effort (2½ hours daily labor, according to Bebel 20 percent of the available labor, if we can believe Hertzka, a patriotic obligation to work five to six hours, if we follow Ballod, whose estimates were considered too modest by Tugan Baranovsky) [5] Oppenheimer believed that 'it is entirely within our power to grant to each member of society an average income as it is at present enjoyed by the millionaire' [6] That Karl Marx, the critic of the naïve underconsumption theory, held similar views will be shown in Chapter 13

What mistakes led to these fantastic assertions? Part of the answer is to be found in the exclusively technological preoccupation of the above mentioned writers when they discuss problems of productivity They compare the result of modern labor with the result of labor not aided by modern machinery and find that the labor time necessary to produce a given article has often been reduced by an astonishing degree Then they speculate how large the total national product could be if all labor were supported by the most modern machinery In addition, they emphasize the advantages of mass production and seem to believe that costs can be lowered *ad infinitum* as the volume of production increases Carried away by their enthusiasm,

[4] Franz Oppenheimer *Die soziale Frage und der Sozialismus* (Jena Gustav Fischer 1925) pp 183 184

[5] See Ludwig Pohle *Kapitalismus und Sozialismus* 4th ed, ed by Georg Halm (Berlin Julius Springer 1931) pp 125 126.

[6] Oppenheimer *op cit* p 187

they forget to count the labor needed to produce capital goods; they neglect the labor needed to distribute the output of mass production through transportation and commerce; they overlook the fact that many improvements in production techniques concern products which are of only minor importance to the consumer (pins, buttons, pencils, envelopes), while the main items in the consumers' budgets (shelter, food, clothing) are still relatively expensive to produce; they overestimate the possibilities of mass production because they forget that, as production grows, diseconomies develop which lead to increasing unit costs; and, above all, they fail to see that we cannot produce all the machinery which we should like to employ, because present consumption cannot be reduced *ad libitum*.

The effort of the Soviet Union to accumulate capital at a rapid rate, and at the cost of an exceedingly low standard of living for the masses, shows that scarcity of capital is not a special feature of the capitalist economy. Those who blame capitalism for its unequal income distribution and its correspondingly high rate of saving should not blame it in the same breath for an inadequate supply of modern machinery.

If the problem of capital accumulation is essentially the same in any social economy, socialists could still try to base their claim to greater productivity on the assertion that technical knowledge would develop faster in a society with government ownership of the material means of production.

Why competitive capitalism should be blamed for a lack of inventiveness and technological progress is hard to see; rather, the bureaucratic, collectivist systems should be made to defend themselves against this criticism. Conservative economists, however, go too far when they take it for granted that government-controlled economies could not develop new techniques. The tremendous concentration of scientific research in government laboratories which developed the atomic bomb must dispel forever the fears of those who identify the advent of socialism with the end of scientific progress.

Some confusion exists concerning inventiveness and initiative. We must distinguish between scientific research on the one side and the practical application of newly invented techniques on the other. Research as such seems to be rather independent of the economic order in which we live. It is only when we come to the actual introduction of new methods, to innovation—a process which is disturbing and distasteful to the bureaucrat—that the private enterprise system may have the edge over collectivist systems. The totalitarian system, on the other hand, has the advantage where extremely expensive research and production processes have to be financed at the expense of consumers.

Productivity and Profitability

Socialist writers often maintain that what is profitable is not necessarily productive and that, accordingly, the private enterprise system must not be trusted to achieve a high degree of productivity To discuss this well known criticism, we shall try to determine, first of all, the meaning of the terms "profitability' and "productivity"

Profitability is easily understood An economic activity is profitable if it leads to profits, that is, to an excess of total revenue over total cost Profit ability can be expressed with some precision in monetary terms where product prices and factor prices are given But for this very reason government activities are often not profitable Many government services can not be sold, however costly and productive they may be The government can sell postage stamps but not flood control or preparedness in case of war

Productive is what improves permanently the possibility of satisfying our wants The term "productivity" is not limited to the private enterprise economy as is the term "profitability" However, it is too elusive to lend itself to quantitative measurements Furthermore, the quantity of the social product is not alone significant, its quality and composition are equ illy important The larger physical output of a dictatorship economy could be inferior to the smaller output of a system in which production is directed by the consumer Similarly, the product of a system with more equal *income distribution may mean more, in terms of want satisfaction,* than the equally large product of a country with a more pronounced income stratification

To get a firmer grasp of the problems involved in this conflict between productivity and profitability, we have to go back to one of the most fundamental concepts in economics—value Anything that has value must be useful and scarce If it is abundant, a good cannot have value in spite of its utility In economics we are exclusively concerned with goods that are scarce in relation to our wants With these goods we have to be careful to maximize the satisfaction of our wants

If value is the product of utility and scarcity, we can increase value either by increasing the utility of the commodity or by increasing its scarcity

Now we can see when productivity and profitability coincide and when they are opposed to each other Anything that increases the profitability of a firm by increasing the usefulness of its products tends, at the same time, to be productive, activities, on the other hand, which increase profits by increasing the scarcity of the product, or by wasting productive resources, tend to reduce the productivity of the economy

Since, under competitive conditions, businessmen are not free to raise

prices of the goods they produce, or to force down prices of the factors of production they use, they must take pains to use the most economical methods of production and try to serve the consumer as best they can. Producers will reduce costs by substituting factors of production for one another, so that scarce factors are replaced wherever possible by more abundant factors. In addition, producers will try to "rationalize" production through improved techniques in order to lower the unit cost of production. By these activities they increase the profitability of their firms and set factors free for other productive employment.

Under reasonably competitive conditions the capitalist producer will always be eager to introduce newer and better techniques and to disturb an existing equilibrium. Equilibrium means that he can merely cover his cost of production, that competition has succeeded in eliminating that difference between cost and revenue for which he is striving. In his endeavor to re create the profit margin, the capitalist entrepreneur is the driving force behind technological change.

The capitalist producer follows the command of the consumer; but as far as new products are concerned, the initiative of introducing them lies with the entrepreneur. In his attempt to introduce new products, the capitalist entrepreneur fulfills an important function and assumes a substantial risk. Some writers have criticized the considerable amount of waste caused by the incessant attempt to create new consumers' demand for new products. But the discussion sometimes tends to go off on a tangent at this point or, rather, to return to the problem of unequal income distribution. If capitalism is condemned because it produces unnecessary things while essential products are, relatively speaking, in short supply, the basic trouble is to be found in a faulty income distribution and not in the attempt of the entrepreneur to satisfy a demand of his own creation. Whether this demand will materialize and remain effective is for the consumer to decide. If the consumers do not want the new article, resources have been wasted. This is the price which we pay in capitalism for the incessant attempt to advance into unexplored territory. Whether this price is too high cannot be decided in objective terms.

We are entitled to conclude from the foregoing statements that profitability and productivity tend to coincide when, under reasonably competitive conditions, businessmen (1) endeavor to reduce costs through factor substitution, (2) introduce better production techniques, and (3) anticipate correctly consumers' demand. In all these situations the activities of capitalist entrepreneurs are utility-creating and not scarcity-creating. This argument rests on the assumption, however, that the producer has the function of satisfying existing or potential demand and that questions of income distribution are eliminated from the profitability-productivity controversy.

Profitability and productivity do not coincide where profits are increased

by methods which increase the scarcity of commodities, either artificially, through monopolistic practices, or through the waste of productive resources.

The profit motive cannot be trusted in this respect. It is selfish and unmoved by social obligations. Only when they are checked by competition will those who aim for higher profits be induced to undertake the laborious tasks which increase the productivity of the economy. To remove the safeguard of competition means to open the door to monopolistic practices by which profits can be obtained through the creation of artificial scarcities. The next chapter will deal with these monopolistic problems.

Unfortunately, the elimination of monopoly is not always sufficient to create an ideally competitive situation. There can be too much as well as too little competition. Too much competition may lead to a waste of resources when efforts are unnecessarily duplicated or when too much is spent on advertising. The high mortality rate of small business, the competition of four gas stations at an intersection, milk distribution compared with mail distribution, the excesses of radio and television advertising, cutthroat competition between giant firms, and other similar examples have been used to show that we pay a high price for competition. These charges cannot be dismissed with the argument that competition is necessary and worth a high price. Where we do find waste, we should try to eliminate it. Much can be done without creating monopolistic controls. Where the regulation of competition implies monopolistic organizations or government controls, we must proceed with caution, balancing the diseconomies of excessive competition against those of bureaucratic or monopolistic controls.

Competitive waste is sometimes not as great as it seems. Take as an example the high mortality rate of small business. The fact that nearly a third of those entering business will discontinue within a year has been considered proof of wastefulness, but no particular waste need be involved. "Entries and exits of individuals with negligible capital, which build up the heavy count of births and deaths, may be compared with labor turnover; they consist largely of the self employed who hire no help and who move in and out according to the shifts in opportunities for self-employment as against employment for others." [1]

American history shows that unregulated capitalism tends to exploit natural resources (forests, soil, natural gas, oil, etc.) in a way which is eminently profitable for private enterprise in the short run but extremely wasteful for the economy as a whole in the long run. A well known example is the cutting of virgin timber by private firms at a cost at which reforestation becomes impossible from the profit angle, as long as these exploitative methods are competitively applied. Another famous example concerns the exploitation of oil. Because underground pools of oil are in-

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[1] A. D. H. Kaplan, *Small Business: Its Place and Problems* (New York: McGraw-Hill Book Company, Inc., 1948), p. 234.

dependent of property boundaries at the surface, the discovery of oil leads to a wild outbreak of drilling completely neglectful of efficient methods of exploitation, which would require treatment of the oil pool as a unit.

Government action clearly becomes imperative whenever the circumstances demonstrate that profit motive and competition are lacking in conscious social purpose. Care must be taken, however, that government regulation accomplish its purpose and is not merely misused to establish monopolistic controls.[8]

In other situations, capitalism is criticized with less justification. Suppose that a crop is not fully harvested because the price of the additional supply would not pay for the extra amount of labor and capital. To have harvested the whole crop would not have been profitable. Would it have been productive? Hardly, since the loss caused by the additional application of labor shows that the labor could be more effectively applied in other fields of production. The impression of waste is created by the virtual destruction of a product which could have been enjoyed by many people, at home or abroad, had only its harvesting not depended on profitability. But income distribution (domestic and international) and the whims of nature rather than the profit motive are to be blamed.

Stock exchange speculation has been criticized as the prototype of profitable but unproductive capitalist activity. In reality, stock speculation performs a useful function in maintaining a permanent market for securities and does not, as is often believed, divert capital from potentially productive employment. Loanable funds, used by a speculator to buy securities, are passed on to the seller of the security and are not tied up. Even an increase in security prices does not absorb capital, because the purchasing power spent by the speculator is always to be found in the hands of the seller [9]

Capitalism has been criticized (1) for wasting its resources in outmoded productive processes where modern methods are already available; and (2) for introducing new machinery at a rate which eliminates old equipment before it has been fully used. These two criticisms cannot both be right. New production techniques are not introduced unconditionally; they are introduced when they lower the costs of production. The decision will depend on considerations as the following: what is the cost of the machine; what rate of interest has to be paid for loanable funds; how much in terms of wages will be saved through the substitution of capital for labor;

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[8] Cf. Fritz Machlup, *The Political Economy of Monopoly* (Baltimore: The Johns Hopkins Press, 1952), pp, 299-304.

[9] It must be admitted, however, that the stock market does not necessarily establish correct security prices, for those who buy and sell on the stock market are not interested in long-run production trends. Either they are ignorant or they are professionals who use their skills, not in correcting the mistakes of the ignorant, but rather in trying "to beat the gun" or "to outwit the crowd." Cf. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan & Co. Ltd., 1936), pp. 151-156.

how will the efficiency of production increase, and what will be the unit costs of production?

Price and cost calculations will supply the correct answers Often the new machine will be introduced and the old machine will continue to be employed, while the price of the product will adjust itself to the lower costs of the new production technique The producer who uses the old machine cannot expect to earn the going rate of interest However, as long as he can earn some interest on his old investments, he will use the old machine rather than throw it on the junk heap A more satisfactory method of weighing old against new methods of production could hardly be found The new method, if it does lower the cost of production, will be introduced, and the old method will be discontinued only if it cannot compete even after complete depreciation of the old equipment We note that the entrepreneurs who introduce the new techniques are those who will not suffer from depreciation more than they gain through the change, and that those who suffer more than they gain are powerless to stop progress unless they are protected through a monopolistic market position

Capitalist production, though unplanned, *steers clear* of these two pitfalls in connection with technological progress Competitive capitalism does not insist that investments be protected until they are fully paid for on the basis of original cost, nor does it insist on the exclusive use of the newest techniques of production It steers a rational middle course which can hardly be improved upon in a socialist economy

Later we shall see that totalitarian systems are in danger of choosing the best *technical* solutions because they do not have a comprehensive pricing process which would permit them to make the best *economic* decision

We do not include in our list of possible deficiencies of capitalism cases in which the productivity of the system is being impaired by wrong government policies, particularly those which interfere directly and clumsily with the pricing process These policies are often the result of a desire to help individual groups whose market position is deteriorating In some instances government action may be justified, for instance, when the nature of demand and supply in special markets leads to excessive price fluctuations But basically wrong are policies which try to perpetuate the economic position of given groups in the face of a permanent decline in the demand for their services or products The artificial maintenance of prices under such conditions leads to misallocations of the factors of production and reduces the productivity of the economy in terms of the products which consumers want

Since policies which would fall under this category contradict the very principle on which the functioning of the capitalist system is based, it would be wrong to blame the system for these violations of its code Democratic government must learn to formulate its policies in conformity with the logic of the economic system on which it is based

CHAPTER 7

CAPITALISM AND MONOPOLY

The Problem of Monopoly

A capitalist economy is supposed to be a competitive economy; but those fighting the competitive struggle and driven by the profit motive strive, whenever possible, to eliminate competition because competition tends to destroy their profits. Since monopoly is the outgrowth of the competitive struggle—the monopolist being the final victor—it is correct when Eduard Heimann says that "monopoly is the annulment of competition and at the same time its logical conclusion." [1]

The substitution of monopoly for competition changes the very nature of the capitalist economy, because monopoly eliminates one of the economy's major driving forces, competition, and leaves the others, self-interest and the profit motive, unchecked. Monopoly violates the capitalist philosophy of individual freedom. A philosophy based on the idea of *free* private enterprise cannot accept a monopolistic concentration of economic power without giving up its very foundation.

There is no denying, on the other hand, that modern technology often requires huge production units. To some observers monopoly is simply the outgrowth of mass production. If monopoly should be the precondition of the application of modern production techniques, we should have to accept monopolistic controls whether we like them or not. Monopolistic practices are therefore often defended on technological grounds, and it is also argued that monopoly is still subject to substantial competitive pressure. Monopolistic practices, furthermore, seem to be a method of avoiding the wastes of cutthroat competition, which may easily develop when the competing firms are few in number and large in size. We must not forget that the classical ideal of competition rested on the assumption of a large number of

[1] Eduard Heimann, *Soziale Theorie des Kapitalismus* (Tübingen: J. C. B. Mohr, 1929), p. 38.

small producing units It may well be asked whether orderly production and supply under monopolistic conditions cannot be superior to the chaotic conditions of cutthroat competition

In this controversy a clear-cut answer is not possible Economic theory has worked out a series of models from pure monopoly to pure competition General conclusions about the social economic consequences of monopoly or partial monopoly have, as a rule, not been derived from these models These models tried to show how profit is maximized under varying conditions, a problem referring to the individual firm rather than the economy as a whole

Regarding the social-economic consequences of monopolistic concentration of economic power, some generalizing statements can be made We begin with a discussion of the case against monopoly

The Case Against Monopoly

One of the most dangerous consequences of monopolistic power for the social economy is *the removal of the automatic protection of consumers and producers, through competition, against excesses of self-interest*

> The public will not tolerate the mere fact of being dependent upon the good will of a private monopolist to use his power humanely Such power amounts to "taxation without representation" and is regarded as tyranny, quite apart from the weight of the taxes the ruler may impose Competition, then, is the option the public has of dealing with anyone who may wish to deal with it, and this option frees it from servitude But it also frees the producers and dealers from the obligation to serve which could be laid upon them if the public did not have this option [2]

As long as competition is sufficiently strong, we can assume that exploitation of buyers (and, in the case of monopsony, of sellers) is impossible, the prices charged cannot long remain above the cost level *The monopolist has the power to restrict output* and to increase his profit by artificially increasing the scarcity of his product In the case of monopoly, profitability does not always coincide with productivity The profit motive, when controlled by competition, leads to constant effort, higher efficiency, and an increased social product The producer under conditions of pure competition[3] has no reason to decrease his output He can sell at the mar-

[2] Reprinted from *Social Control of Business* 2d ed, by J M Clark p 126 Copyright 1939 Courtesy of McGraw Hill Book Company Inc

[3] 'Pure competition exists if the seller thinks that at the market price he could sell as much as he wanted while at a higher price he could sell nothing at all"—Fritz Machlup, *The Political Economy of Monopoly* (Baltimore The Johns Hopkins Press, 1952) p 14

ket price whatever he produces because his individual supply can be considered as an infinitisimally small part of the total supply. Only if the market price should fall below his average cost of production will he, in the long run, reduce output or stop producing altogether. The monopolist may reduce his output and increase his selling price. His decision will depend on the elasticity of demand for his product and on his production costs. If restriction of output and a higher price will lead to higher profits, the monopolist will restrict output. The profit motive leads in this case to contraction rather than expansion of production. This is the very negation of everything the capitalist philosophy stood for.

The existence of *monopoly removes the self-generating character of private initiative*. The monopolist does not have constantly to re-create his profit through actions which, under the fresh breeze of competition, would be likely to benefit society. A monopolistic position creates an atmosphere of privilege, the very atmosphere the classical philosophy set out to destroy. We should not forget that early capitalist society, as Adam Smith and Benjamin Franklin saw it, was predominantly a society of small businessmen. At that time everybody had a fair chance to own the tools of his trade. "But the tools of trade which are protected by the unanimous voice of the lawmakers of America are not the tools by which modern workers maintain their lives." [4] Competition has ceased to be what it used to be when wise men believed they could safely rely on its regulative and stimulative functions.

The pricing process of the capitalist economy rests on the assumption of sufficient price flexibility. Prices should adjust themselves to changes in demand, in production techniques, and in the supply of the factors of production. Changes in prices would cause the necessary adjustments in production, in the demand for the factors of production, and in individual incomes. If we assume that *monopolistic price control is identical with price rigidity,* we come to the conclusion that the price mechanism will lead to results which are deviations from the optimum which could have been achieved under competitive conditions. Under the assumption of a stable supply of money and a stable general price level, monopolistic policies will tend to reduce the prices of products which are produced under competitive conditions; and if the competitive industries cannot lower their cost of production, the result may be increasing unemployment.

The monopolist not only restricts output if restriction promises to increase his profit; he also secures a *larger* share of a *reduced* national income, thus cutting doubly into competitive incomes. *The monopolist's increased share is not derived from any social-economic function.* While it is possible to impute wages, interest payments, and competitive profits to "functional" contributors to the social product, no such imputation is pos-

[4] *Final Report and Recommendations of the Temporary National Economic Committee* (Washington, D. C.: United States Government Printing Office, 1941), p. 6.

cases of restriction add up to a substantial decrease of the national output, but it is also likely that the total effect is worse than the mere addition of single instances. The functioning of the price mechanism will suffer when the savings from monopolistic profits are forced into competitive fields. Not only will the competitive industries be exposed to the extra pressure which the elimination of competition in the monopolistic industries brings about; they are, at the same time, faced with inelastic prices for products which they must buy from the monopolies. If the economy should be sensitive to oversaving, because of inadequate profitable investment opportunities, conditions would be made worse by monopolistic practices.

The Apology for Monopoly: Competitive Admixtures

The picture regarding monopoly can, however, be painted in brighter colors. Some observers believe that the case against monopoly has been overstated and that monopoly, far from being the negation of the classical philosophy, is much more likely the latter's logical and consistent adjustment to the era of mass production.

The strongest argument in defense of monopoly is the reminder that *monopoly in pure form is rarely found.* Since the arguments against monoply center around the alleged absence of competition, the defenders of monopoly can attempt to prove that competition is maintained in forms which, though less clear-cut than the cases of pure and perfect competition,[10] are still sufficient. These forms of competition are the following:

(1) THE COMPETITION OF ALL PRODUCTS FOR THE BUYER'S DOLLAR. This statement cannot accomplish very much in defense of monopoly. It says that the monopolist has to face a demand situation which is determined not only by the effect on sales of the respective monopolistic prices chosen, but also by the prices of all other products which the consumers' dollars may buy. The statement can serve as a reminder that even the monopolist's power is not unlimited. He has to consider the elasticity of demand for his product and also the cross elasticities, i.e., the effect on the quantity demanded of changes in the prices of *other* products.

(2) THE COMPETITION OF SUBSTITUTES OF DIFFERENT RANGES OF PROXIMITY. This argument could lead us into very complicated problems of modern economic theory. Meant as a defense of monopoly capitalism, the argument says that even the monopolist will have to consider the price policy of the makers of products which are

[10] See footnote 3. "Perfect competition requires that everybody is free to move unlimited amounts of productive resourcess into any field that looks promising to him. . . ."—Machlup, *op. cit.*, p. 19.

close substitutes for his own product and therefore liable to make the demand for the monopolist's product more elastic But even in the case of a close substitute, the dissimilarity may be great enough to offer substantial possibilities for monopolistic profits

(3) POTENTIAL COMPETITION According to M J Clark,

> A considerable part of competition is exerted by competition which is not actively in existence In other words, the expectation of stirring up active competition is enough to restrain businessmen from following extortionate policies, especially if it is fortified by recollections of painful experiences in the past This takes many forms, including (1) the expectation that new plants will be built or new enterprises launched, (2) the possibility that producers serving other markets will reach out and invade this one, if prices go high enough to make such an invasion profitable, or (3) the possibility of stirring up cutthroat competition among existing producers in a trade where rivalry is now on a tolerant live-and-let-live basis [11]

All this, of course, is a question of the degree of monopolistic power and monopolistic profits The more attractive the monopolistic profit, the stronger must be the armor of the monopolist Consideration of the ease of potential competition is important because the *invisibility* of this form of competition may cause monopolistic power in capitalism to seem stronger than it is

When monopoly rests on a temporary arrangement—as in a cartel—competition remains a potential menace, a fact which limits monopolistic practices If the restrictions imposed upon the members of the group seem greater than justified by the gain deriving from control of the market, members will leave the cartel This type of monopoly is an armistice between competitive battles and is therefore constantly under the shadow of a potential outbreak of hostilities

(4) MONOPOLISTIC COMPETITION This is the competition in differentiated products by many sellers [12] It is not a case of competition of substitutes unless we define substitutes to include the "same" goods when sold by rival makers [13] But the two cases shade into each other The differentiation in the case of monopolistic competition is not of such an appreciable degree that each field would constitute an "industry" of its own 'Differentiation may be based upon certain characteristics of the product itself . It may also exist with respect to the conditions surrounding its

[11] Clark, *op cit*, p 136
[12] See Fritz Machlup, "Monopoly and Competition A Classification," *American Economic Review*, XXVII (September, 1937), 447
[13] Clark, *op cit.*, p 129

sale." [14] These cases are a blending of monopolistic and competitive elements. In its differentiated field or location, the firm is a monopolist. The differentiation acts as a deterrent to the entry of competitors into the "field." But other firms may offer a product only slightly different in quality or conditions surrounding the sale. In scientific language: competition is neither pure nor perfect. In pure competition an identical article is offered for sale by many firms. It makes no difference from whom the buyer buys, and the seller can sell at the market price whatever he produces. The demand for branded articles, on the other hand, is not perfectly elastic. At a lower price the producer will sell more than at a higher price. However, since there are other sellers selling similar products, such as different makes of automobiles or different brands of cigarettes, the demand for a particular brand will decrease as other firms enter the industry. Advertising is characteristic of this type of competition. We do not find much advertising in cases of pure monopoly and none at all in cases of pure competition.

We have listed this hybrid of monopoly and competition in order to emphasize the strong admixture of competition and monopoly in capitalism. The ubiquity of this form of monopoly (or competition) suggests, however, that the monopolistic element is stronger, though more diffused, than the rare appearance of pure monopoly may lead us to believe. Monopolistic competition may not be exposed to the severe criticism which is directed against monopoly in general. But it has this in common with the negative features of monopolistic practice: the firm which supplies a differentiated product has the choice between different prices and may be induced to restrict output in order to increase profits.

(5) COMPETITION FROM THE NEW COMMODITY. Joseph A. Schumpeter refers to *"the competition from the new commodity, the new technology, the new source of supply, the new type of organization* (the largest-scale unit of control for instance)—competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives." [15] This kind of competition is, according to Schumpeter, so much more important than competition in the ordinary textbook meaning of the word "that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly; the powerful lever that in the long run expands output and brings down prices is in any case made of other stuff." [16] This argument is an important reminder that long-run problems of economic growth should not be forgotten. The argument is not so strong for the short-run analysis, which may well include whole business cycles.

[14] Edward Chamberlin, *The Theory of Monopolistic Competition* (Cambridge, Mass.: Harvard University Press, 1936), p. 56.
[15] Schumpeter, *op. cit.*, p. 84 (italics are mine).
[16] *Ibid.*, p. 85.

The Apology for Monopoly: Further Arguments

The theory of countervailing power[17] suggests that we do not confine our search for restraints of monopolistic power to only one side of the market, i e, the various kinds of competition just outlined, it reminds us that *restraints may appear also on the opposite side of the market, where monopolists meet monopsonists* and vice versa Thus the monopsony of employers' associations is met and counterbalanced by labor unions These considerations are important for a realistic appraisal of capitalism, but they cannot prove that all market parties can unite with the same ease or success We shall see, furthermore, that the power of these groups may be additive rather than countervailing, as when strong labor unions and industrial monopolies join forces in the exploitation of the consumer

If *monopoly* really leads to a curtailment of production, it *releases factors of production* which can be used in other fields Monopolistic policies, therefore, lead to restrictions in individual plants, firms, and industries but need not decrease total production The net effect of monopoly is not a reduction of the national product but a change in its physical aggregate Lower wages will help to absorb into competitive fields those who cannot find employment in the monopolistic industries, and saved-up monopolistic profits will lower interest rates and lead to increased investment in competitive firms This argument is correct only if it can be assumed that the economy will maintain a high employment level Even then, however, it is clear that consumers do not get the selection of goods which they would have bought under competitive conditions We can argue, on the other hand, that this diversion is relatively unimportant when compared with the influence of unequal income distribution on the contents of the social product

Perhaps the most frequently heard argument in defense of monopolistic practices consists of references to the unhealthy conditions of cutthroat competition, which may make its appearance where there are only a few large firms in a field and the entrance of just one more competitor precludes fair rates of return for all concerned. The same argument can be formulated as follows The ideal competitive economy was based on small but numerous business units Modern industrial economy with its big mass-production units no longer conforms to this picture Since mass production is here to stay, new forms of market behavior must be found The way back to pure and perfect competition is closed *If we disapprove of cutthroat competition we must be willing to admit some sort of market control*

The tendency toward mass production does not, as a rule, lead to the

[17] Cf John Kenneth Galbraith *American Capitalism The Concept of Countervailing Power* (Boston Houghton Mifflin Company, 1952), Chaps 9, 10

survival of only one producing unit. The advantages of mass production are limited. After an optimum point is reached, a further increase in the size of the producing unit would lead to decreasing returns. On technological grounds the optimum size will often be reached before one production unit comprises the whole industry. Several firms will supply the market. Monopoly is therefore not the direct outgrowth of the advantages of mass production. But wherever the market is supplied by only a few firms, the normal adjustment of supply to changes in demand may be impeded. The addition of one more production unit may make competition too severe, while a reduction of output is difficult to achieve under these conditions. Marginal firms may eventually be forced to shut down, but even the marginal firms have made large investments in fixed capital which they will write off before they stop producing. Thus entry into an industry will be easier than withdrawal from it.

Fritz Machlup points out that the extent to which concentration has proceeded is entirely out of proportion to so-called technological necessities or economies.

> Most of the growth of corporate empires during the last fifty or sixty years was not a matter of technological integration but rather financial integration of control. And this integration and concentration of control in larger and larger corporate units was, of course, directly related to the building up of monopoly positions both in the sense of reducing the number of actual competitors in the field and in the sense of reducing the ease with which potential competitors could enter the field.[18]

We must make sure that industrial efficiency is not used as an excuse for industrial empire building. The optimum size for producing units can be reached, as a rule, without the interlocking financial controls which are characteristic of the concentration of economic power in capitalism. But "if prices are to be managed and administered, if the Nation's business is to be allocated by plan and not by competition, that power should not be vested in any private group or cartel, however benevolent its professions profess to be." [19]

Schumpeter suggests that *monopolistic practices* can often be considered *a necessary protection against the uncertainties against which insurance is*

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[18] Machlup, *The Political Economy of Monopoly*, p. 239.

[19] TNEC, *Final Report*, p. 15. John Stuart Mill had already reached this conclusion; a hundred years ago. He wrote, "When . . . a business of real public importance can only be carried on advantageously upon so large a scale as to render the liberty of competition almost illusory, it is an unthrifty dispensation of the public resources that several costly sets of arrangements be kept up for the purpose of rendering to the community this one service. It is much better to treat it at once as a public function." —*Principles of Political Economy* (New York: The Colonial Press, 1899), I, 141.

not possible He argues that monopolistic restrictions, which seem synonymous with loss of opportunities to produce, are often unavoidable incidents of a long-run process of expansion which they protect rather than impede 'There is no more of paradox in this than there is in saying that motorcars are traveling faster than they otherwise would *because* they are provided with brakes "[20] This argument cannot easily be refuted, though we may well ask whether the necessary controls should be vested in a private monopoly and 'whether investment on balance will not be more restricted than encouraged if we foster investment by 'leaders' through restricting investment by 'followers'"[21] Schumpeter admits that his argument 'does not amount to a case against state regulation It does show that there is no general case for indiscriminate 'trust busting' or for the prosecution of everything that qualifies as a restraint of trade "[22]

The argument that monopolistic policies lead to a less flexible price system is difficult to refute, but it *is* equally *difficult to prove* Edward S Mason has pointed out that 'it is frequently inferred, because many prices are now rigid, that the degree of monopoly control must now be greater in the economy than it was at some time in the past All of these deductions seem to be highly dubious to say the least "[23] The fact that prices of agricultural products fall during a depression without much decline in output does not justify the conclusion that if industrial prices had declined output would have been maintained[24] This conclusion would be correct only if the price determining variables were the same in both cases The problem of the economic relevance of price rigidities cannot be solved without an analysis of all these variables Since the derived demand for capital goods resulting from changes in the demand for consumers' goods is an extremely sensitive variable, it is quite impossible to conclude that industrial prices and output would behave like agricultural prices and output were it not for monopolistic practices in industry Under demand conditions as they prevail on the market for capital goods during a depression, it is likely "that in the most conspicuous cases price rigidity is motivated precisely by the low sensitiveness of demand to short-run price changes within the practicable range "[25] This argument can hardly be used in defense of monopolistic practices, however If the chances for a revival rest on profit expectations, and profit expectations depend in turn on cost-price relations, it is quite possible that price rigidities postpone the upswing Schumpeter argues that the refusal to lower prices strengthens the position of industries which adopt such a policy, but it is doubtful that this argu-

[20] Schumpeter, *op cit* p 88
[21] Machlup *Political Economy of Monopoly*, p 68
[22] Schumpeter, *op cit* p 91
[23] Edward S Mason, "Price Inflexibility," *Review of Economic Statistics*, XX (May, 1938) 55
[24] *Ibid*
[25] Schumpeter, *op cit*, p 95

ment can afford similar comfort to industries which are buyers of monopoly products.

Adolf Weber[26] suggests a simple psychological reason for the public's negative attitude toward concentration of economic power. The public, he says, is always dissatisfied with some features of the capitalist economy. Since the private enterprise economy is atomistic and unplanned, responsibility cannot be fixed upon individual firms as long as these firms are relatively small and numerous. Responsibility can be fixed, however, either upon the government which "interferes" with private business or upon monopolies which "exploit" competitive business and the consumer. Quite obviously, Weber concludes, government and monopolies are blamed for almost all the shortcomings of the capitalist economy.

Summing up these points in defense of monopoly, we can say that pure monopoly is only infrequently found and that competition remains effective in many forms; that original bargaining power leads to countervailing power; that monopoly does not reduce total production as much as it changes the direction of production; that modern production units have grown too big for a normal competitive process and that monopolistic market control is sometimes preferable to cutthroat competition; that monopoly protects against uncertainties which, if no protection were possible, would prevent large-scale investment in new fields; and that price rigidities are, perhaps, not as strong an argument against monopoly as it may seem.

Whether the arguments for or the arguments against monopoly are stronger cannot be decided on purely theoretical grounds. The problem has a normative character. The norm on which monopolistic policies can be evaluated is difficult to establish. If we acknowledge the principle of competition, why stop those who emerge victorious? If we acquiesce in glaring inequalities of income distribution, why get excited about monopolistic profits? If we eulogize the profit motive, why not idolize men who have driven it to the extreme? Under these conditions, antimonopolistic policies are liable to be half-hearted, incomplete, and inefficient attempts which often dare not be consistent lest we jump from the frying pan of monopoly into the fire of government control and government ownership.[27]

In order to find our way through the maze of this problem we must be guided by a firm grasp of the working principles of the market economy.

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[26] Adolf Weber, *Allgemeine Volkswirtschaftslehre,* 4th ed. (München und Leipzig: Duncker und Humblot, 1932), II, 175.

[27] "Perhaps the basic difficulty had its origin not in the vastness and complexity of business but in the confusion of the American mind. Americans feared big business, but they admired it, too. They wished to protect themselves against the dangers of monopoly, but also to enjoy the benefits of mass production and the elimination of costly duplication. They believed in government regulation of business, but believed with equal fervor in the virtues of private enterprise and 'rugged individualism.' What they really wanted to do was to purify the trusts, not to smash them."—Allan Nevins and Henry Steele Commager, *The Pocket History of the United States* (New York: Pocket Books, Inc., 1942), p. 304.

of the government's antimonopolistic policy is, therefore, a patent law which achieves its ends with a minimum of danger that the patent may become "an invitation to predatory litigation."[30]

The government can try to support competitive enterprise through a tax system which encourages competitive small business against monopolistic large enterprise. Such a policy, however, may easily become arbitrary and discriminate against the economies of mass production. Monopolistic profits are, unfortunately, much too elusive to be made the subject of special taxation, and yet it is monopoly rather than mere bigness or efficiency against which such a policy should be aimed. More successful may be a credit policy which sees to it that small business has access to credit at reasonable rates of interest. These credits could come from public credit institutions, or they could be given by private institutions under public guarantee.

Competitive pressure may be exerted by public corporations. Care must be taken, however, that this competitive pressure is not unfair, as when the cost of government agencies is artificially reduced or losses are covered through public revenues.

The government may control prices charged by public utilities. These public utilities, though monopolistic for technological reasons, are still embedded in a competitive economy, and thus the task of cost determination and price regulation is not unmanageably difficult. The socialist economy will have to face a more difficult task: where production is completely in the hands of the government it is very difficult to correct monopolistic pricing through a comparison with competitive pricing.

The government may acquire the ownership of monopolistic industries. Although this action is often referred to as "nationalization" or "socialization," it does not imply the introduction of socialism if government ownership remains the exception to the rule of private enterprise and if such nationalization is based upon clear evidence of monopolistic power. The difference between government ownership and government control is not too decisive. As a matter of fact, public ownership might be preferable to public control because it would "obviate expense, overlapping and, above all, friction, if, instead of there being a controlling authority *plus* a controlled one, control and operation were united . . . in the same hand."[31]

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[30] "In order to curb monopolistic abuse, consideration should be given to proposals for compulsory licensing of patents, and for licensing without restriction upon licensee or buyer of the patented article. Since much of the control exercised by monopolies proceeds not so much directly from the patent as from aggressive use of infringement suits and the costs they impose upon small competitors, appropriate protection of the defendant in such cases should be provided."—Howard S. Ellis, "Monopoly and Unemployment," in Postwar Economic Studies No. 4, *Prices, Wages, and Employment* (Washington, D. C.: Board of Governors of the Federal Reserve System, May, 1946), pp. 85-86.

[31] A. C. Pigou, *Socialism versus Capitalism* (London: Macmillan & Co. Ltd., 1937), pp. 45-46.

Without competition, the market economy cannot work, but it can work under conditions of less than pure and perfect competition It must be our aim to keep competition as strong as feasible, to see to it that notoriously weak bargainers are strengthened to eliminate monopolies which are not technologically justified and control those which are needed, perhaps even through government ownership And we must abstain, of course, from policies which indirectly foster the growth of private monopoly

Restriction of Monopolistic Practices

The government to be consistent, should not follow policies which in directly tend to strengthen monopolistic tendencies in the private sector of the economy Competition rests on the free movement of commodities, labor, and capital Whenever the government restricts mobility, it tends to strengthen the monopolistic forces in the economy A case in point is the protection of domestic producers against foreign competition through tariffs, quotas exchange controls and the like Once foreign competition has been excluded, it seems only natural that domestic producers should try to regulate competition in the sheltered domestic market The chances that they may achieve a monopolistic position are strengthened But the government s inconsistency is not restricted to its anticompetitive policies in international trade In the domestic sphere too the government will often be subject to pressure by interested groups to introduce policies which stifle competition Regulatory policies may be defensible, however, where the government tries to strengthen the countervailing power of previously weak bargainers

We have seen that the concentration of economic power was to a large extent achieved with the aid of corporation laws which permitted monopolistic controls that far exceeded the needs of modern technology These laws (which were often very lucrative for the states that passed them) were not designed to minimize the dangers of monopoly If we really mean to deal decisively with the monopoly problem, we shall have to rewrite these laws We shall have to deprive corporations of such powers as the right to own stocks in other corporations or the possibility of effecting interlocking officeholding [28]

Patent laws are a special case of well meant government policy which may support monopolistic tendencies Patents are supposed to promote the progress of science and useful arts Experience often shows, however, that patents can be used for a system of industrial control (even on an international basis) which stifles new enterprise, divides markets, limits productive capacity, and shields against charges of conspiracy [29] An important part

[28] Machlup *Political Economy of Monopoly* pp 236-249

[29] Cf Wendell Berge *Cartels Challenge to a Free World* (Washington D C Public Affairs Press 1944) pp 38 39

of the government's antimonopolistic policy is, therefore, a patent law which achieves its ends with a minimum of danger that the patent may become "an invitation to predatory litigation." [30]

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Are Labor Unions Monopolistic?

A discussion of the monopolistic character of modern capitalism would be incomplete without a consideration of the bargaining power of labor Is labor being exploited or are, on the contrary, the labor unions themselves monopolistic organizations which may even share in the monopolistic profits of industry at the expense of the consumer and of unorganized labor?

Most economists agree that unorganized labor cannot hope to bargain successfully on the labor market Unorganized labor does not have the necessary monetary reserves which would permit it to withdraw its services temporarily from the market, it lacks mobility (both geographical and occupational), which would permit ready movement to more highly paid jobs, it is menaced by unemployment, which creates pressure to accept any offer rather than to have to face idleness, and it faces employers who are comparatively few, can come to secret agreements, and have a much better knowledge of the market situation

Labor can improve its position through organization The original monopsonistic bargaining power of the employers is now being met by the countervailing monopolistic power of the employees Ideally speaking labor can now appropriate that extra profit which employers could pocket before labor was organized

Labor unions undoubtedly are monopolies in the economic sense of the word Whether their monopolistic position will lead to wages which are higher than they would be under ideally competitive conditions will depend on many circumstances The following will be most decisive the strength of the monopoly, that is, the amount of control over a given kind of labor supply, the position of the other contracting party (even a union cannot cut into profits where no profits are made), the general economic situation (unemployment, full employment), and the framework of economic policy within which labor and management bargain

To approach the same question from a different angle, we can ask at whose expense a labor union may succeed in raising the wages of its members Quite a few possibilities exist

(1) Already mentioned was the case in which labor simply appropriates the share of the employers profits which was withheld from labor as long as its bargaining position was weak

(2) Labor unions may be able to get a share in the monopolistic profits of certain industries—at the expense of consumers and of other labor groups A strong union can actually help a monopolistic industry to fortify its position, as when nation wide bargaining raises labor costs to potential intruders

(3) A monopolistic labor group can raise its wages at the expense of la

bor by restricting entry into the organized field and by increasing the competitive pressure on other labor markets.

(4) Unions can try to get a share of the competitive profits of industry, but at the danger that marginal producers will have to quit, with the consequence that unemployment increases. This is another case of increasing the share of one group at the expense of other workers.

(5) The danger of unemployment can be reduced when a liberal monetary policy permits general price inflation. In this case the increase in real wages will not be as great as the increase in money wages, but organized labor will still gain at the expense of parts of the population which cannot increase their money income.

(6) Wage rates can be increased, without inflationary consequences, if the increasing purchasing power of wage earners is met by a sufficiently increased supply of commodities. However, we must not make the mistake of assuming that wages should be more or less automatically raised in firms or industries whose efficiency has been increased. The logic of the price mechanism requires an upward adjustment in wage rates only if the demand for the particular kind of labor involved has increased in relation to supply. For the same kind of labor the same wage rates must everywhere prevail—not different rates depending on the varying profitability of the firms involved; or, to be exact, the differences ought to be limited to the amounts needed to bring about the proper allocation of labor.

How to deal with the labor problem is one of the most crucial and difficult issues faced by modern economic policy. Let us assume that we know how to deal with industrial monopolies, so that a pact between industrial and labor monopolies is no longer feasible. Let us assume, furthermore, that we have achieved conditions of high employment. In a full employment economy labor has a very strong bargaining position. "Labor," of course, is a term which oversimplifies matters. The labor factor is not homogeneous; it is subdivided into numerous "noncompeting" groups among which occupational mobility does not exist, at least not in the short run. Each organized group will try to obtain for itself the highest possible wage rates, quite without consideration of the general economic consequences of its policy. Indeed, no other attitude can be expected of labor (or any other group) in times of peace. Nobody, therefore, sees to it that the total wage bill, which is the result of all bargaining processes on the labor market, will be correct in terms of aggregate demand. In the full employment situation, which we assumed to exist, it is likely that aggregate demand will exceed the amount at which price stability can be maintained. The explanation is that employers will be willing to concede wage increases, provided they in turn can count on raising their prices.

The monetary authority, to which the problem of price stability is entrusted, could see to it that the total amount of spending is sufficiently cur-

tailed All the monetary authority need do would be to regulate the supply of money This was the conservative concept of monetary policy In this case

> wage negotiations were conducted, as it were, within a steel framework not absolutely rigid indeed, but known not to be indefinitely extensible If the framework is scrapped, if monetary authorities are always prepared to create without question whatever *flow of money* is needed to discharge whatever *wage bill* is needed to reconcile full employment with whatever *wage rate* is demanded by the Trade Unions, they have indeed abdicated from exercising that sovereignty over the standard of value which we thought we had committed to their charge [82]

As yet nobody has found a solution for this dilemma which seems to make it impossible to achieve simultaneously the three aims of (1) collective wage bargaining, (2) full employment, and (3) monetary stability Two of the problems could always be solved if we dared neglect the third one we can let powerful unions bargain within the mentioned steel framework—at the price of unemployment, we can let unions bargain successfully in a high employment economy—at the price of creeping inflation, or we can maintain both full employment and monetary stability—if we take from labor (and other groups), as totalitarian systems do, the power to bargain collectively In categorically rejecting this third choice we must remain aware of the fact that inflation may eventually lead to depression and that mass unemployment is a sure way of creating the political precondition for totalitarianism

We shall see later on that a liberal socialist system would face the same difficulties Only totalitarian systems seem to have simple solutions to offer —at the price of freedom

[82] D H Robertson *Utility and All That* (New York The Macmillan Company, 1952), p 91

CHAPTER 8

CAPITALISM AND UNEMPLOYMENT

Frictional and Technological Unemployment

In the model of a free market economy, unemployment is, by definition, excluded. In a real market economy, whether capitalist or socialist, a moderate amount of frictional unemployment is unavoidable. Adjustments to changing conditions imply factor movements and, since labor does not enjoy perfect occupational or geographical mobility, we must expect some idleness in consequence of changes in demand and in production techniques.

With this type of unemployment we are not concerned. It would exist in any economic system (even a totalitarian) which attempted to adjust production to changing conditions. A realistic interpretation of such "frictional unemployment

> . . . legitimately allows for various inexactnesses of adjustment which stand in the way of continuous full employment: for example, unemployment due to a temporary want of balance between the relative quantities of specialised resources as a result of miscalculation or intermittent demand; or time-lags consequent on unforeseen changes; or to the fact that change-over from one employment to another cannot be effected without a certain delay, so that there will always exist in a non-static society a proportion of resources unemployed "between jobs." [1]

Some of these instances of frictional unemployment are probably more serious in a market economy than in a centrally planned economy. Capital-

[1] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan & Co. Ltd., 1936), p. 6.

ism is characterized by free choice of consumption and of occupation Adjustments to changes in demand and supply will therefore be more frequent and difficult in a free than in a regimented economy The really dangerous cases of unemployment, however, are of a different nature

Before we turn to these more important forms of unemployment, we shall have to consider a special case of frictional unemployment which has played an important part in the socialist critique of capitalism—technological unemployment

Many writers believed that a constantly growing use of capital goods would lead to ever-increasing unemployment Machines would be substituted for labor, unemployment would press wages down, and the increased social product could not be sold, owing to the insufficiency of purchasing power in the hands of the people We met with this argument before when capitalism was criticized for its inability to reach high levels of productivity (see above, Chapter 6) Now we have to find out whether capitalism must suffer from permanently increasing technological unemployment

Classical economics rejected the above argument Jean-Baptiste Say pointed out "that a product is no sooner produced, than it, from that in stant, affords a market for other products to the full extent of its own value," [2] and John Stuart Mill explained,

> could we suddenly double the productive powers of the country, we should double the supply of commodities in every market, but we should, by the same stroke, double the purchasing power Everybody would bring a double demand as well as supply everybody would be able to buy twice as much, because every one would have twice as much to offer in exchange [3]

This theory took for granted that increased efficiency of labor would lower the unit cost of production and that, at lower prices, purchasing power would be set free to purchase additional commodities To produce these commodities, more labor would be needed and the technologically unemployed would be absorbed by an ever-expanding production. That the process need not be deflationary was already suggested by Say, who pointed out that in such cases of increased "traffic" merchants would well know how to find substitutes for the product serving as a medium of exchange [4]

The Say-Mill argument was merely a consistent (though highly simplified) application of the principles of the free market economy to problems of technological change (see above Chapter 3, pp 28-29) The his-

[2] Jean Baptiste Say, *A Treatise on Political Economy* (Philadelphia John Grigg, 1830), p 78

[3] John Stuart Mill, *Principles of Political Economy* (New York The Colonial Press, 1899), II, 77

[4] Say *op cit.*, p 78

tory of the nineteenth century, with its remarkable record of creating employment for a rapidly rising population, shows that the theory of the automatic long-run absorption of the technologically unemployed came much nearer to the truth than did the gloomy predictions of the pessimists who expected ever-increasing unemployment, even within a stationary population, as the result of rapid industrial progress.

While Say and Mill were right in rejecting the theory of a general overproduction, they overestimated the case with which the capitalist economy adjusts itself to technological and other changes. We know from experience that the capitalist economy does not expand steadily, that it is subject to cycles of prosperity and depression. These wavelike, self-aggravating movements are the manner in which the capitalist system reacts to outside shocks. We must study this cycle of prosperity and depression because we must know the causes of the disease of unemployment before we can prescribe the proper remedies.

The Business Cycle

How the capitalist economy tends to swing in cycles of increasing and decreasing employment, of prosperity and depression, can be indicated by the following sketchy remarks.

Assume that a period of depression changes into revival. This change may be caused by an accumulated replacement demand, by innovations, by an improved cost-price relation, or by government action.

Unemployment, excess capacity of industrial plant, and stocks of materials in different stages of production permit a substantial expansion of output under the impulse of improved profit expectations. The rate of interest is low and will be kept low through credit expansion. Because production can be increased, the expansion of credit need not raise the general price level.

As the revival is financed by credit expansion, as new money flows into circulation, the national income increases. Newly employed men will spend part of their newly earned income on consumers' goods. New consumers' goods will be ordered and produced, and the money spent will become income of an ever-widening circle of those who participate, directly and indirectly, in the production and marketing of consumers' goods. This is the so-called "multiplier-effect."

Part of the newly created income will be saved. These savings will be invested (that is, spent on capital goods), because an increased demand for consumers' goods will cause an increased demand for capital goods. This "derived" demand may easily be "accelerated" or "magnified," owing to circumstances which a simple example will explain.

Assume that the production of consumers' goods, such as shoes or elec-

tne fixtures, bas been carned on at full capacity when, upon a rise in in come, the demand for consumers' goods increases by 10 per cent. Assume, furthermore, that in order tn produce these consumers' goods a considerable amount nf capital goods is needed Let us say that the production of 1,000 units of consumers' goods per year requires 500 units of capital goods These units, constituting plant and equipment, have to be replaced at a rate which depends nn the average durability of the capital goods Assuming an average durability nf 10 years, we must replaee 50 units each year The capital gnnds industry bas to produce these 50 units per year to maintain the flow nf 1,000 units of consumers' goods per year Because we assumed that the plant was fully used, a 10 per cent increase in the demand for consumers' gnnds (from 1,000 tn 1,100 units) will require 550 units of capital equipment instead of only 500 The new demand for investment goods, added to the normal replacement demand of 50 units, raises the production nf capital gnods from 50 to 100 units, or by 100 per cent Since the assumed increase in consumption was nnly 10 per cent, we see that the "derived ' demand for capital goods has been greatly magnified.

If we assume the existence of unused plant capaeity, this principle of magnification will not work immediately or its effect will be weakened. However, tbe principle remains a powerful tool of analysis in the explanation of business cycles, as we shall presently see

Increasing investment causes employment, income, and consumption to grow, and increased consumption, in turn, increases investment still further How an upswing, once under way, gathers momentum is easy to un derstand Revival propels itself into prosperity while continuous credit expansion finances the absorption of unemployed factors of production

But the upswing must come to an end when full employment is reached and when the expansion of credit has to be stopped to avoid a dangerous price inflation The capitalist economy reacbes a state of higb employment nnly to be fnrced intn recession and depression by disproportionalities which have developed in the economy during its upswing

As consumers' goods productinn and capital goods production increase side by side, they stimulate their mutual grnwth But as unemployed re sources are gradually absorbed it becomes increasingly difficult tn expand both consumers' goods production and capital goods production At full employment, investment can be increased only at the expense nf consumption, and consumption, nnly at the expense nf investment This constitutes a situation of great instability

Both consumers' and capital goods production are geared to a mutual rate of growth which it is impossible tn maintain Investment cannot con tinue tn increase when consumption decreases, it cannot even increase when the *rate* of grnwth nf consumption falls or when consumption is maintained at a given level Using this latter case as an example, we remember that an increase in consumption from 1,000 to 1,100 units (an increase of

10 per cent) caused an increase in capital goods production from 50 to 100 units (an increase of 100 per cent). Assuming that consumption is maintained at 1,100 units, the capital goods industry would have to maintain a replacement demand of 55 (10 per cent of 550 units of capital). This would mean a fall in investment expenditure from 100 to 55. The mere maintenance of a given level of consumption is, therefore, not enough to maintain investment. On the other hand, if investment is not continued at the former level, it will not be possible to maintain consumption, owing to unemployment in the investment goods industry.

We see that the principle of acceleration of derived demand helps to explain the downswing of the business cycle. Another cause of the rise and fall of investment in capitalism is cyclical changes in the interest rate.

Owing to credit creation, the rate of interest is low during the earlier part of the upswing, lower than it would be if the supply of loanable funds were limited to savings. The comparison of low rates of interest with high rates of profit leads to a rising investment activity, for the value of capital goods is high when high returns are capitalized by low interest rates. Suppose that a capital good costs $1,000,000 to produce and that its expected yearly net return is $50,000. If the rate of interest should fall from 5 to 4 per cent, the value of the capital good would tend to rise from $1,000,000 to $1,250,000 (because $50,000 would be a 4 per cent return on $1,250,000).

But let us assume now that, as the economy approaches full employment, further credit creation must be discontinued to avoid a dangerous price inflation. Credit creation was permissible as long as a substantial growth of the social product prevented price inflation. Once full employment is reached, however, we can no longer count on further substantial growth. Credit creation must be stopped, the interest rate must increase. Production processes which were considered profitable at a lower rate may no longer be profitable. To use our example once more: at the same expected return of $50,000 a capital good could be considered to be worth only $833,333 if the rate of interest had risen from 4 to 6 per cent.

There is still another important factor in the explanation of the overdevelopment of the capital goods industry during the prosperity period. This is the time-consuming character of investment goods production. If it takes considerable time before the products or services to be produced with the new capital goods emerge, it also takes time before the increased supply of these products and services has its effect on prices. Profits therefore remain high for a considerable period, and during this time too many new investment projects will be started. But when these are finished and begin to increase the supply of goods and services, the rate of profit may fall precipitously. In our example the real return would then be substantially lower than the anticipated $50,000.

These considerations reveal the probability that during a prosperity pe-

riod expansion projects will be undertaken in the investment goods industries which cannot be finished under the same favorable price-cost relations that prevailed when the projects were started This difficulty could be overcome only by a reduction of the rate of interest or by a further growth in consumption Obviously, these two conditions are mutually exclusive if we are determined to avoid further credit creation Interest rates could be decreased only by a rise in savings Savings, however, can be increased only by a reduction of consumption, and it is on consumption that the demand for investment goods depends [5]

Once the decline in investment goods production is accounted for, it is easy to show that unemployment and a decline in consumers' spending will cause the economy to contract still further The impact of a declining demand upon a supply that only recently has been greatly expanded leads to a rather general fall in prices Many individuals and firms are now reluctant to purchase because they expect prices to fall still further The most strategic price, however, does not fall readily When goods are hard to sell and when credits remain frozen, in the form of unsold goods, the striving for monetary liquidity becomes general and tends to keep interest rates high Furthermore, the so-called real rate of interest, that is, the rate which is corrected for changes in the general price level, rises as prices fall

Part of the downward adjustment of commodity and factor prices is necessary We must not forget that relative price movements are essential for a regrouping of the factors of production, for a correction of the existing state of "overinvestment" These price adjustments, however, are drowned in a deflationary spiral Thus we can see that "the forces of contraction may drive the economy farther away from the equilibrium" and that "the equilibrating tendencies may not have time to come into play, or, if they do come into play, may not be strong enough to restore equilibrium, since the disturbance of the latter will have been still further increased in the meantime" [6]

Keynes' General Equilibrium Theory

Our considerations concerning the disequilibrating forces of contraction are likely to weaken our confidence in the pricing system of the capitalist economy Where, we have to ask, will this deflationary process end?

To this question modern theory offers a clear answer According to Lord

[5] Of course not all private investment depends directly on consumption. This is only true for what we can call "induced investment "Initial" or "autonomous" investment arises from innovation and the hope that future consumption will finally justify the outlay But even initial investment will be determined by anticipated profits and rates of interest and will be subject to exaggerations owing to delayed price effects

[6] Gottfried von Haberler, *Prosperity and Depression* (Geneva League of Nations, 1939), p 355

Keynes,[7] a new equilibrium will be found and the downward process arrested when the national income has declined to the point where the net savings forthcoming at this level can be absorbed by net investments. Once all the income earned is again spent on either consumers' goods or producers' goods, there is no reason why the deflationary process should continue.

When profitable investment opportunities are lacking even at low rates of interest, the level of the national income will fall to the point where the public wishes to spend its whole income on consumers' goods (that is, where savings are exactly offset by dissavings or consumers' credit). When savings are zero, no investment is required to compensate for savings. The income level at which the whole income is spent on consumers' goods may be called the "basic" level of the national income.[8] At this level a given volume of consumption is self-perpetuating because there is no danger of further "leaks" in total spending. This point is a point of equilibrium, but a point which may be far below full employment. For purposes of theoretical analysis this is the true rock bottom of the depression.

The Keynesian theory explodes the argument that the price mechanism tends constantly toward a full employment equilibrium; it shows that the price system does not always work satisfactorily in real life. It also shows that the disequilibrating forces may finally come to rest at an equilibrium position which is not brought about by full employment of productive resources but rather by such poverty that no saving occurs.

The classical theory assumed an accumulation of uninvested savings during depression, i.e., an increasing supply of loanable funds, which would put the rate of interest under pressure; and it expected that, at low interest rates, enough investment outlets could be found. In Keynes' theory savings do not accumulate but are destroyed by a fall in the national income.

In the Keynesian analysis the national income itself becomes an equilibrating factor. If investment falls short of what savings would be at a given income level, the national income will shrink. As the national income decreases, consumption as well as saving will decrease; and it is to be expected that, as the nation becomes poorer, saving will fall proportionately more than consumption. Changes in national income thus tend to maintain equilibrium between investment and saving. The national income is lowered or raised until equality of investment and saving is established. Instead of one full employment equilibrium, this analysis suggests the possible existence of any number of equilibrium positions. All of them but one, however, are underemployment equilibria.

The contribution of this general equilibrium theory lies not only in the analysis of the self-deflationary process of contraction but also in the sug-

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[7] Keynes, *op. cit.*, Chap. 18.

[8] See Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York: W. W. Norton and Company, Inc., 1941), pp. 184-185.

gestion that the capitalist economy may, at times, lack reliable automatic powers to extricate itself from stagnation The economy not only may hit the rock bottom of the depression but may stay there for an indefinite period if no new investment opportunities are found and if, furthermore, we are not willing to substitute government action for the automatic forces which are lacking

Keynes' theory seems to emphasize depression and stagnation rather than revival and upswing Actually Keynes did not consider stagnation any more normal than is a high level of employment The pessimism of modern economics grew out of the stagnation of the thirties During these difficult years of seemingly permanent mass unemployment it was argued that the mature capitalist economy simply lacked sufficient investment opportunities as a result of "the combined effect of the decline in population growth, together with the failure of any really important innovations of a magnitude sufficient to absorb large capital outlays"[9] After less than twenty years this attitude seems overly pessimistic

It is probable that the pessimism of modern economists rests also on a misconception of the so-called consumption function True, it can be assumed that the rich save proportionately more than the poor, but we need not come to the conclusion that the saved portion of the national income will increase in percentage terms with an absolute increase of the national income over the years On the contrary, a relatively strong increase in consumption may occur if the increase in income is, in part, inflationary rather than real, if income distribution is gradually altered in favor of the lower-income brackets, or if the appearance of new consumers' goods and the tendency to "keep up with the Joneses" reduce thrift in favor of consumption

The danger that our investment outlets will fall short of the amount needed to absorb all the savings which would be forthcoming at a high income level was decidedly exaggerated during the great depression Nevertheless, because investment depends on profit expectations, it is to be expected that investment will sometimes be insufficient to sustain a high income level The economy may then lack the power to extricate itself from a stagnation into which it need not have fallen in the first place if the deflationary spiral could have been halted

Once we admit that the national income may shrink, that expenditures for consumers' goods may decline, and that savings, instead of pressing upon the credit market, may disappear through hoarding and debt cancellation, we have to admit, too, that anticipated rates of profit may be very low When overinvestment leaves an aftermath of unused capital goods and discourages temporarily even normal replacement demand, and when the anticipated profits of yesterday turn out to be the losses of today—then

[9] *Ibid*

it is not at all surprising that investment opportunities disappear even in the atomic age.

Depression may therefore develop into stagnation, and nobody can predict when such stagnation will be overcome. Stagnation can be overcome only when the inducement to invest is strong enough to necessitate credit expansion. Investment will then be greater than saving, and the national income will increase, just as it had to shrink as long as investment tended to fall short of intended savings.

The strength of the impulses needed to overcome stagnation depends on the severity of the antecedent downward process, the depth it reaches, and the duration of the stagnation at this level.

Only a very few economists can be found any more who would suggest that we wait until the necessary stimuli appear of their own accord. The consensus seems to be that stimuli can be artificially provided. Only regarding the nature of the stimuli, and the timing of their application, does substantial disagreement exist.

Planned Economies and Unemployment

We have now acquainted ourselves with unemployment as it may exist in a capitalist economy. No doubt, to a large extent the unplanned character of capitalism is responsible for unemployment. The system is characterized by independent decisions of individuals and firms concerning consumption, saving, and investment. The price mechanism is supposed to integrate these decisions. But the necessary adjustments are sometimes dangerously delayed, and the equilibrium they produce is then an underemployment equilibrium. A system which rests on the independent decisions of millions (who do not know of each other's actions) must suffer from miscalculations. Furthermore, many decisions concerning investments must be made for a rather distant future about which present prices can tell little. Because the processes of production are time-consuming, it is probable that parallel, independent actions of private firms will destroy the very demand-supply situation on which they were based.

The difference between a planned and an unplanned economy is illustrated by the process of self-deflation which is characteristic for the capitalist economy but which would be unnecessary in a planned economy. Had a centrally planned economy made the mistake of overexpanding its investment goods industry, it would be faced with adjustment problems similar to those of the capitalist economy. Having reached the full employment level, it could expand capital goods production only at the expense of consumers' goods production and vice versa. But in making the necessary adjustments, the planned economy would prevent the starting of a deflationary spiral.

Let us assume, for example, that the authorities of a planned economy had embarked upon a five year investment program which was somewhat too ambitious In order to carry it through they had reduced consumption to a minimum Now that the five years are over, the authorities realize that they have underestimated the magnitude of the capital construction required before the planned increase in goods and services can be realized Not only are the production targets of the plan not achieved, but many new production facilities are left unfinished and therefore incapable of any production at all The planning board has now a choice between two policies It can admit its miscalculation and leave part of the investment goods idle or unfinished thereby causing temporary unemployment in the capital goods industry Labor will be transferred to consumers' goods industries The alternative is to cut down consumption for another few years in order to employ labor and productive resources in the completion of the unfinished investment program There is no reason to assume that the planned economy would suffer from a process of cumulative self deflation Because total spending could easily be maintained and since investment and employment would not depend on anticipated profits, the planned economy could likely maintain a higher level of income and employment than could the capitalist economy

No premature conclusions about the superiority of the planned economy should be drawn at this stage We have to remember that the capitalist economy under consideration was characterized by economic freedoms with which we do not wish to part The totalitarian solution of the employment problem rests on the partial abolition of these freedoms and is thus unacceptable to most citizens of the Western democracies if it can be shown that the market economy, when properly regulated, can successfully deal with the employment problem

In the following chapter we shall see how capitalism can succeed in maintaining a high level of economic activity without having to change the basic features of the market economy

CHAPTER 9

CAPITALISM AND FULL EMPLOYMENT

Introduction

In an attempt to discuss capitalism and full employment we meet, first of all, with the difficulty that it is impossible to give a reasonably precise definition of full employment. It has been suggested by Abba P. Lerner that we have reached full employment when inflation begins.[1] But price inflation begins very gradually and may even continue when employment falls. Similarly vague is William H. Beveridge's definition that full employment means "having always more vacant jobs than unemployed men."[2] This definition reminds us that labor enjoys a sellers' market under full employment, a situation which tends to be inflationary. Bertil Ohlin[3] has pointed out that such a situation is not necessarily a blessing. It leads to bottlenecks and an excessive labor turnover, and its inflationary impact can be such that the government may be tempted to turn to price controls and rationing. In the field of international trade such a state of affairs would be accompanied by balance of payments difficulties, with the probable result of foreign exchange controls.

These considerations suggest that it may be better to be less ambitious, to aim for something less than "full" employment. Or, to put it differently, a high employment level, though one of the most important aims of economic policy, is not the only goal. We should not try to reach it at all cost. A reasonable degree of monetary stability and the maintenance of eco-

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1 Abba P. Lerner, *Economics of Employment* (New York: McGraw-Hill Book Company, Inc., 1951).
2 William H. Beveridge, *Full Employment in a Free Society* (New York: W. W. Norton & Company, Inc., 1945), p. 18.
3 Bertil Ohlin, *The Problem of Employment Stabilization* (New York: Columbia University Press, 1949), Chap. 1.

nomic freedom may be at variance with the desire to reach or to maintain full employment

That economic freedom may conflict with a full employment policy is already implied in the relative ease with which a totalitarian regime may handle the employment problem Even a nontotalitarian system may be forced into direct controls (and a corresponding loss of freedom) if it overemphasizes the employment aspects of its policies Clearly, then, we have to find a compromise between our employment policies on one side and monetary stability and economic freedom on the other

When employment policies are being formulated in a private enterprise system in peace, we assume that we do not want to make major concessions concerning our economic freedoms In the following discussion we take for granted, therefore, that free collective bargaining is maintained, that the price system remains free of controls (with the exception of monetary and fiscal controls), and that currency convertibility is maintained Furthermore, since most of the direct controls which we want to avoid are the outgrowth of monetary instability, we have to achieve a high level of economic activity with a minimum of price inflation

The Employment Budget

We have seen that unemployment occurs in capitalism when, in a deflationary spiral, both investment and consumption expenditures are declining It must be our aim to stop this fall in aggregate demand How can this be accomplished?

Since the unregulated private enterprise economy does not provide automatic safeguards in this respect, the maintenance of a sufficient amount of total spending must be made the duty of the government This policy concerning aggregate spending should be designed to protect the economy against the evils of inflation as well as those of deflation To avoid inflation, modern governments have always tried (though not always successfully, by any means) to keep the money supply sufficiently limited Monetary policy has also been intended to guard the economy against harmful price deflations More recently we have learned, however, that monetary policy does not work equally well in both directions Inflation can always be avoided if we are prepared to face other possible economic consequences of such a policy—unemployment and price deflation rather than price stability Monetary policy alone may, then, not be able to reverse a deflationary trend and to create employment. The monetary authority can make more money available, but it cannot make people borrow If private enterprise does not anticipate profits, firms will not be willing to borrow even at the lowest practicable interest rates Monetary policy has then reached the end of its rope, and it will be necessary to turn to fiscal policy

In its attempt to maintain an adequate amount of aggregate spending, modern government uses a new type of budget, "which will be concerned with income and expenditure of the community as a whole, not only with public finance, . . . will take the manpower of the country as a datum and plan outlay to that datum rather than by consideration of financial resources."[4] Of course we do not mean to say that the government must embark on deficit spending. As a matter of fact, the idea of a full-employment budget may be subscribed to by persons of rather widely diverging viewpoints. Such a budget would not be more than a survey which would estimate forthcoming expenditures, in both the private and the public sector of the economy, and it could be used as a gauge for anti-inflationary as well as for antideflationary measures.

Differences of opinion exist, of course, regarding the policy conclusions which should be drawn from the results of such a survey. Policies could be proposed which are incompatible with the institutions of capitalism. But we shall see that a variety of powerful measures can be employed which do in no way interfere with the pricing process or the economic actions of the members of a market economy. On the contrary, the maintenance of adequate aggregate demand will create a healthy climate for the operations of the market economy.

The acceptance of this new attitude toward government employment policies is astonishingly unanimous in the United States today. Only concerning the details of the policy and its aggressiveness and timing do the experts disagree. The nature of the policies chosen will depend in part on how high we set our sights—whether we consider, for instance, 5 per cent or only 3 per cent of unemployment bearable—and on how much importance we attach to monetary stability and economic freedom.

In analyzing the elements which constitute the total flow of a nation's expenditures, we can distinguish the following categories:

(1) Private consumption expenditures (C).

(2) Private investment expenditures (I).

(3) Public expenditures financed by regular revenue (R), i.e., without increasing the public debt.

(4) Public expenditures financed by loans (L) which increase the public debt.

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[4] Beveridge, *op. cit.*, p. 30. In the United States the Employment Act of 1946 declares "that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power."

(5) The balance of international trade (B) which may be either positive (excess of exports over imports) or negative (excess of imports over exports).

It is desirable that aggregate expenditure $(C + I + R + L) \pm B$ be equal to F, which stands for the output capacity of the economy at or near full employment If F is larger than E, which stands for aggregate expenditure, the difference would be U, or unemployment If E is larger than F, the result will be price inflation

Government policies can try to influence one or more of these factors As a matter of fact, the elements of aggregate expenditure are so closely interrelated that policies which influence one cannot help having some effect upon one or more of the others

For example, if the government tries to finance increased expenditures by raising tax rates, it must be assumed that we pay for the increase in R by a decrease in C or I or both Increased government expenditures out of loans L, on the other hand, will increase C and I if the money borrowed was newly created money This money, when successfully injected into the income stream, leads to higher consumption and, via higher consumption, to increased investment As C and I increase, R will automatically increase unless the government decides to use its increased revenue to reduce its debt If the debt was held by the banks, the effect may be deflationary, if it was held outside banks, C and I may increase

Suppose that government analysts have found that during the next year aggregate expenditure E will probably be short of F, the output capacity of the economy Suppose, furthermore, that the government is charged with the responsibility of proposing ways and means by which total outlay can be increased Three different roads are open

(1) Whatever the government does, it desires neither to change its expenditures and revenues nor to increase the public debt

(2) The government is willing to increase its expenditures but unwilling to raise the public debt

(3) The government permits the public debt to increase

When public expenditures and the public debt remain unchanged, the possibilities to increase aggregate expenditure are limited to measures which might induce private economies to spend more on consumption and investment We have already seen that monetary policy can do relatively little if private investment refuses to be induced by low rates of interest, and a change in the tax structure (which leaves tax revenues unchanged) can, at the best, have only a modest influence on C plus I There are many other policies which we could consider (agricultural and commercial policies, for instance) But, again, these policies can affect the magnitude of aggregate demand only if the government is willing to spend more than before (for farm support or foreign loans and grants).

When government expenditures are increased but the public debt is not permitted to rise, the effect on aggregate spending is not much better. This might seem to be a conservative road to high employment because it avoids "deficit spending." Actually, however, it would turn out to be, in practice, less conservative than deficit spending. If R is to be increased without an increase in L, money has to be collected through additional taxation, and the increase in R is therefore compensated by a decreased C and I.

> In a serious depression, elimination of the bulk of unemployment by this method would probably require exorbitant increases in expenditures and of tax rates, implying a drastic redistribution of income, and the system would soon become incompatible with a free-enterprise economy. . . . This may sound paradoxical to many, for what most conservatives are afraid of is a deficit and a growing public debt. Their obsession with the public debt may thus lead them into a much more dangerous alley.[5]

Let us now consider the only effective means by which government can increase aggregate expenditure; i.e., policies whose application has the common effect of raising the public debt at least temporarily.

To understand the economic implications of a rising public debt we have to distinguish two kinds of government borrowing:

(1) If the money is borrowed from savings, the effect is similar to the effect of increased taxation; i.e., total expenditure will increase only under special circumstances. The savings of the private sector of the economy, instead of being cut into by taxation, are borrowed by the government, with the result that there will be an increase in total expenditure only if the borrowed sums would have run to waste for lack of profitable investment opportunities. The government, not limited to profitable investments, can spend this money and maintain a given income level. Whether the method of borrowing uninvested savings is superior to the method of taxing them away depends partly on psychological circumstances. The effect of government borrowing upon private investment may conceivably be less unfavorable than the effect of taxation, unless the increase in the public debt is considered very dangerous by the business community.

(2) The government can borrow newly created funds. If newly created money is spent by the government, private expenditures C and I need not decrease, and total spending is likely to grow with favorable effects on C, I, and R. Here, then, we find the most powerful instrument at the disposal of the government in the latter's effort to raise aggregate spending.

Cases (1) and (2) have entirely different monetary implications. If

[5] Gottfried Haberler in "Five Views on the Murray Full Employment Bill," *Review of Economic Statistics*, XXVII (August, 1945), 108-109.

newly created money is spent by the government, the government's policy rests on credit expansion If the government gets hold of private savings, total expenditure increases only if these savings would have remained unspent, owing to insufficient private investment activities Credit creation, far from being detrimental, is, on the contrary, decisive After all, we want to combat a dangerous deflationary process Credit creation is not necessarily harmful and will not lead to price inflation before a state of high employment is being approached We shall see, however, that credit creation is a weapon, the amount and the timing of its application must be used with skill

These brief remarks about the different kinds of government borrowing show that it is hopelessly inadequate to criticize government deficit spending as such Borrowing savings from the people and borrowing newly created funds from the banks are two entirely different policies, and even inflationary borrowing cannot be judged unless we consider carefully the circumstances under which such a deficit is incurred

Government Deficit Spending

The government may incur a deficit in two ways It can spend more than it earns from taxation, that is, it can raise expenditures without raising taxes But it can also spend more than it receives by maintaining its expenditures while simultaneously cutting taxes

(1) By reducing taxes while maintaining public expenditures at a given level, the government may stimulate either private consumption or private investment This tax-remission program designed to increase total expenditure will be favored by those who want to keep direct government spending as small as possible and to achieve the desired effects, in the main, through the private sector of the economy Such a policy seems to be better adapted to the basic structure of the capitalist economy than is increased government spending The difficulty is that, given a certain amount of government deficit created through tax remission, the effect on total expenditure is much less certain than it would be if an equal amount had been spent by the government *C* and *I* may not increase by the full amount of the tax reduction To achieve an increase of this amount in total aggregate expenditure, a larger budget deficit will probably be needed in the case of tax remission than in the case of government spending Once more, therefore, the seemingly more conservative approach may lead to the bigger deficit

(2) Direct government deficit spending is the most powerful and reliable way to increase or to maintain employment through an adequate total outlay In making sure that newly created money will actually be spent (and not only used to increase liquid balances), deficit spending "is the logical se-

quel of central bank policy." [6] If the monetary authority is willing but not able to maintain enough money in active circulation, deficit spending can be used as a device to increase expenditure, because government investment is independent of profit anticipations. Deficit spending, of course, is not independent of monetary policy. But in this relation between monetary and fiscal policy the monetary authority is only *permitting* the expansion, whereas deficit spending supplies the driving force.

Before we discuss different kinds of deficit spending we must understand clearly that the government does not as a rule carry out the production activities which are implied in these spending programs. The government employs the help of private firms, stimulates the demand for the products of private firms, and avoids the mistake of competing with private firms—unless such competition is meant as antimonopolistic policy. Increasing government spending, therefore, is less likely to bring about fundamental changes in our economic system than is often taken for granted.

Deficit spending can be carried through in different ways and with different intentions. We shall distinguish (1) pump priming, (2) countercyclical spending, and (3) permanent deficit spending.

The implication of pump priming is that government deficit spending is a limited and temporary injection of money and that the mechanism (the pump, the market economy), once successfully primed, will be able to continue to operate without further help. Pump priming is a stimulus which pulls the economy out of a depression, the igniting spark which starts a stalled economic machine. It rests on the belief that the private sector of the economy has not lost all its vitality, though it may need help in overcoming the effects of a preceding process of self-deflation. Pump priming does not aim at more than the initiation of a period of revival.

A policy of pump priming is difficult to administer. Our discussion of the principle of acceleration of derived demand shows how difficult it will be to taper off government spending in such a way that total investment, employment, and national income continue nevertheless to increase. Pump priming can succeed only when, with increased optimism, private investments are undertaken which do not depend exclusively, as do induced investments, on the government's initial investment.

A policy of countercyclical spending is more ambitious. In its milder forms it proposes stable tax rates, which lead to fluctuating tax revenues during the business cycle, combined with a shifting of government expenditures (as far as they can be shifted at all) into periods of recession or depression. A more forceful application of the same principle would lower tax rates during the downswing and simultaneously step up government ex-

[6] John H. Williams, "Deficit Spending," *American Economic Review*, XXX (February, 1941), 55.

penditures through public works In both cases the budget would be over balanced during prosperity

The logic of these proposals is obvious The peaks of the cycle would be chopped off and the troughs filled in While economic fluctuations would not disappear, they would be dampened Theoretically, at least, it would even be possible to carry through this countercyclical taxing and spending policy without a permanent increase in the public debt, because the budget could be balanced if we average one period with another and are not pre occupied with a yearly balancing of the budget It is doubtful, though that our democratic processes will enable us to muster the fortitude to apply the principle of compensatory spending with equal zeal to prosperity as well as depression During prosperity we should have to refrain from spending when government revenues increase, in order to be able to pay off the debt which was incurred during the depression

While countercyclical spending is sound economics it is not necessarily appealing to the layman The layman often fails to see that it is sound to spend in bad times and to be thrifty in good times He wants the govern ment's budget to balance every year, the government is to spend in good times but to cut expenditures to the bone when times are bad This was, in deed, the basic mistake of traditional budget policy The government raised taxes and cut expenditures during the downswing, thus accentuating eco nomic fluctuations which originated in the private sector of the economy During periods of prosperity, on the other hand, government investment was superimposed on private investment as increased tax revenues seemed to invite such additional spending An anticyclical fiscal policy means that we give up these understandable misconceptions and that we consider deficit budgeting during depressions a virtue rather than a sin [7]

A countercyclical policy is easy to apply if we confine ourselves to the so-called built in stabilizer This automatically uses the taxing and spend ing processes of the government as a counterweight to fluctuations in the private sector of the economy The Committee for Economic Development states the principles of such a policy as follows

> Set tax rates to balance the budget and provide a surplus for debt re tirement at an agreed high level of employment and national income Having set these rates, leave them alone unless there is some major change in national policy or condition of national life [8]

The advantages of this policy are obvious When national income falls government revenues decline in relation to government expenditures, and

[7] Gunnar Myrdal Fiscal Policy in the Business Cycle' *American Economic Review* XXIX (March 1939), 184

[8] Committee for Economic Development, *The Stabilizing Budget Policy* (New York CED 1950), p 8

vice versa. It is important, of course, that we do not destroy this beneficial effect by raising tax rates and cutting expenditures in depression, and by cutting rates and going on a spending spree during prosperity. The built-in stabilizer rests on the assumption that certain government expenditures will increase automatically as private economic activity declines. Unemployment compensation, farm income supports, and similar relief payments will add to the discrepancy between government receipts and disbursements. Far from being dangerous, this deficit is the crucial feature of the stabilizer.

The more ambitious compensatory policies want to operate with tax cuts and public works programs. They lose, therefore, the advantage of automaticity and require a careful diagnosis of the cyclical position in which we find ourselves at a given point of time. "To make such a diagnosis presents a problem soluble for the past, with hindsight, but hardly for the present, without the gift of foresight." [9] Obviously, it is very difficult to determine just when the government should stop deficit spending and when it should try to overbalance the budget. The record of forecasting is poor.[10] We lack simple criteria. The danger is great that we shall be tempted to use deficit spending whenever a substantial amount of unemployment is present. But if unemployment alone is made the criterion of government spending, government spending might be continued through most of the upswing. Too little leeway would then be left for private investment. Another danger could be that we become too eager to fight pockets of unemployment, which are caused by a normal shift in demand, with the heavy guns of increasing total expenditure.

To the difficulties of forecasting we must add the delay which is generally encountered before countercyclical measures take effect. For "the appropriateness of the action will depend upon how well it fits the situation when it takes effect, not how well it fits the situation when the decision is made.

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[9] Fritz Machlup, in *Financing American Prosperity*, ed. Paul T. Homan and Fritz Machlup (New York: Twentieth Century Fund, Inc., 1945), p. 455.

[10] "The poor record of forecasters in the past warns us to the dangers of this course. Thus in the fall of 1945 virtually all of the economic forecasters predicted that there would be a tremendous postwar slump which would create from 8 to 12 million unemployed by the spring of 1946. This did not occur; and, instead, we had rising production and even more rapidly rising prices with substantially full employment. For us to have embarked on a tremendous program of public works at this time, as the forecasters had urged, would not only have been unnecessary but it would have intensified and heightened the inflation. In fact, the accumulation of a surplus and the retiring of a portion of the public debt beginning in the latter part of 1946 helped to dampen down inflation and prevented matters from becoming still worse. Again in the winter of 1949 the official economic forecasters stated that the real problem was inflation, to prevent which they wanted further restrictive controls. Since it then developed that we were in a recession which continued for some time, the putting into effect of these recommendations could only have deepened the recession."—*Monetary, Credit, and Fiscal Policies* (Douglas Committee Report), 81st Cong., 2d Sess., Sen. Doc. 129, 1950), pp 14-15.

But when the decision is made no one knows what the situation will be when the action takes effect "[11]

But while these difficulties are great, they are not insuperable We can increase the flexibility of fiscal policy to some extent As far as tax reduction is concerned, "it might be possible to short-cut this process by legislation providing for a tax cut to go into effect automatically under certain conditions, or by giving the President authority to reduce certain taxes under specified conditions "[12] Public works can be authorized and blue printed in advance so that they can be started with a minimum of delay This planning is not easy Apart from political and technical difficulties in the budgeting process, we have to find projects which are useful, noncompetitive with private industry, and also of a kind that they can be discontinued without loss as soon as general economic conditions demand that government spending be reduced But it should not be impossible to do some long-run planning in the public sector of the economy, with a view to doing as much as possible of the necessary or desirable construction work (public building, road construction, social housing, flood control, conservation projects) in times of low private investment

We can see that the proper application of countercyclical policy requires considerable moral fortitude True, we have to rid ourselves of the conservative mistake of trying to balance the budget every year But we must also be careful not to fall into the opposite mistake The Committee for Economic Development envisages "the really frightening possibility that we shall oscillate between adherence to the annual balance principle in prosperity and belief in compensatory spending in depression "[13] A tendency in this direction certainly exists, since it is the way of least resistance Deficit spending in this case, would only be interrupted but never reversed, and the public debt would continue to increase even in peacetime Apart from the possible dangers of a growing public debt, such a course could not claim the counterbalancing advantages of compensatory spending, would tend to exaggerate the boom, would lead to inflation, and would permanently enlarge the public sector of the economy

Is Permanent Deficit Spending Compatible with Capitalism?

Permanent deficit spending would become necessary if private investment would prove to be forever too weak to absorb the savings which a high income level would bring forth While such a case seems to be highly un-

11 Committee for Economic Development *Defense against Recession Policy for Greater Economic Stability* (New York CED 1954) pp 31 32
12 *Ibid* p 33 See also "The Problem of Economic Instability," a report prepared under the auspices of the American Economic Association *American Economic Review*, XL (September, 1950) 524
13 Committee for Economic Development, *The Stabilizing Budget Policy* p 7

likely for the foreseeable future, it is interesting to speculate on the consequences of such a situation for the survival of capitalism.

We may be tempted to conclude that a policy of permanent deficit spending would lead us away from the private enterprise system, but it is difficult to envisage the system that would emerge. The following points should be considered:

(1) Private investment would depend to an increasing extent on government expenditures. That it could still remain private investment was shown during World War II.

(2) The character of private investment would change, however, if the inducement of private investment spending were to become the permanent responsibility of the government.

(3) Theoretically, permanent deficit spending could be carried out without price inflation if taxation, the borrowing of private savings by the government, and the growth of output combine to keep inflationary forces in check.

(4) The public debt would grow steadily. We shall see that this need not imply price inflation, but it would have psychological effects and effects on the distribution of wealth and income.

(5) If a lack of private investment opportunities, together with a tendency toward private oversaving, is the cause of permanent deficit spending, a case can be made for a radical change in the tax structure to increase consumption at the expense of saving. If private savings can be decreased to the level of initial (that is, not government-induced) private investment, no further government deficit spending would be needed.

It must be stated again that it is unlikely that a well-regulated private enterprise economy will be in need of such a permanent application of deficit spending or find itself in a position where economic growth has to be checked by an attempt to increase consumption permanently at the expense of saving. If permanent deficit spending occurs, it will be the result of war (hot or cold) and of a wrong application of the principles of countercyclical spending.

The dangers and difficulties which were discussed in connection with deficit spending cannot detract from the fact that an important and even revolutionary change has taken place in our attitude toward the worst danger that faces capitalism. We know now how the problem of unemployment can be solved in capitalism. We have already been reasonably successful in the application of these new policies. That the results were not perfect goes without saying. We have had and will continue to have recessions; and we have paid for high employment the price of a creeping inflation and of an increasing public debt. Has this price been too high?

The Problem of Inflation

Since modern employment policies are creating inflationary dangers, it is necessary that we should end the chapter on capitalism and full employment with a discussion of these dangers

First we must distinguish different inflation concepts

(1) CREDIT INFLATION means creation of money through a process of credit expansion in the banking system The term is neutral Whether credit inflation is good or bad depends on the circumstances and particularly on the state of employment Credit inflation need not lead to price inflation if increasing employment and output offset the increase in aggregate demand

(2) HIDDEN INFLATION is a credit inflation which is invisible because output has risen sufficiently to let prices remain stable or even fall

(3) PRICE INFLATION is characterized by an increase in the general price level If increased demand is considered the main cause of the rise in prices we can speak of a pull type inflation, if rising costs are the cause we can call it a push type inflation It is important that we keep in mind that changes in the general price level are always connected with changes in the relative price pattern This fact is decisive in a market economy

(4) CREEPING INFLATION is a continuous or intermittent price inflation of a relatively modest amount per annum The concept is rather vague Opinions differ regarding what degree of price inflation is modest or tolerable To clarify this matter, Alvin H Hansen suggests the concept

(5) PURE INFLATION, viz 'a condition in which prices rise without any appreciable increase in output' [14] Hansen contends that at no time in our history, nor indeed in that of any other country, can it be shown that price increases have injured the economy and the general welfare if in the period in question the increase in aggregate output has exceeded percentagewise the increase in prices [15]

(6) RUNAWAY INFLATION is what we call a price inflation over which the monetary authority has lost all control It occurs when the public expects prices to rise so fast and so continuously that to save becomes foolish and people tend to spend their money with ever increasing rapidity The result is

[14] Alvin H Hansen, *The American Economy* (New York McGraw Hill Book Company Inc 1957) p 43
[15] *Ibid*

(7) HYPERINFLATION, an inflation of sometimes astronomical proportions, in which voluntary savings are zero, the velocity of circulation of money is extremely high, the government is forced into continuous money creation (since tax revenues lose most of their purchasing power during the process of tax collection), and output falls as a result of enormous distortions which develop in the production process.

(8) REPRESSED INFLATION comes about when the government tries to cure the symptoms of price inflation through a freezing of prices and wages, an attempt which implies rationing and production controls as well.

Credit inflation is necessary when we want to increase aggregate outlay; it supports the most successful attempts to raise the employment level and to check a process of self-deflation. Suppose that we are thereby successful in our attempt to create or maintain a desired employment level and that we can also maintain stable prices. This seemingly ideal state of affairs has been called hidden inflation to point out (1) that a credit inflation has taken place, (2) that the creation of new money has lowered the interest rate, and (3) that investment has been artificially stimulated. The theory of neutral money holds that in the case of increasing productive efficiency it would be better to let prices decline to the lower cost level and that the maintenance of a stable *general* price level leads to a disruptive effect in the structure of *relative* prices.[16] The difference between lower costs and higher prices leads to artificial profits which, together with the lowering of the rate of interest, create the very condition under which overinvestment is likely to develop.

We thus see that some economists do not even consider a stable price level good enough. However, we cannot be perfectionists at a time when simple price stability seems preferable to creeping inflation and yet politically out of our reach. Can we live with creeping inflation if this should be the price for a sustained high level of employment?

Nobody knows the answer, but if it can be given at all it must depend on such factors as the degree of price inflation, the experience of the people with inflation, the rise in output, and the distortions in the structure of production which may result from a cheap money policy. If even a case of hidden inflation is potentially dangerous, the case of creeping inflation is obviously even more critical.

We cannot deny, of course, that more important than the rise in prices is the comparison of the percentage increase in prices with the percentage increase in output. Suppose that output increases more than prices. Is creeping inflation within this margin safe? Again, no definitive answer is

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[16] Cf. F. A. Hayek, *Prices and Production* (New York: The Macmillan Company, 1932).

possible. We must remember that we have to find a politically feasible compromise between employment and monetary stability. It can perhaps be argued that the possible destabilizing effects of credit inflation will be less dangerous in a system in which the government has assumed responsibility for the maintenance of aggregate demand. It may also be argued that the maintenance of a satisfactory state of employment is so important that we must sacrifice for it the considerations of social justice which come to mind when we discuss inflation problems. Price inflation has rightly been called the most unjust of all taxes. But from a general social point of view we must admit that widespread unemployment would be even worse than creeping inflation.

It is most essential that a creeping inflation be kept from developing into a runaway inflation. The psychological nature of the problem makes it impossible to know precisely when such an extreme state would occur. However, we can feel reasonably well protected as long as the inducement to save is not impaired.

It would be dangerous to argue that runaway inflations are a thing of the past, that the government would instantly repress such price developments. True enough, repressed inflation may take the place of price inflation. But repressed inflation may be even more objectionable than price inflation from the standpoint of those who want to maintain the market economy in good working order.

In Chapter 5 we have seen what price fixing implies. Prices are kept below the level which would be determined by demand and supply, and since, at the official price, supply falls short of demand, demand must be restricted by some form of *rationing*. Price control and rationing of selected commodities, however, have the effect of directing excess purchasing power into the markets of other goods whose prices are still free to rise. The production of these commodities becomes more profitable, and the whole production process is given a wrong twist until practically all goods are included in the control scheme.

When price control has reached its logical conclusion, when all prices are frozen, the market ceases to function and central planning must take over. The market economy has become a planned economy. These developments are practically unavoidable in times of total war where a single aim predominates and where freedoms which characterize the capitalist economy are voluntarily and temporarily suspended. The problem takes on a different complexion when these same direct controls are the peacetime result of ambitious full-employment policies of a welfare state. Those who want to maintain a market economy will not be willing to pay this price in terms of economic freedoms for a policy which, after all, cures only the symptoms of the disease. Once we have fully understood the function of relative price movements, we know that a system which freezes all prices either will not work or will work only when the direct controls

have become integrated in a central plan. If production is not centrally guided, repressed inflation will lead to distortions in the production process which can be even more dangerous than those which accompany an open price inflation.

Since in repressed inflation the newly created money is not permitted to find a vent in price inflation, the pressure mounts. The "inflationary gap" between commodities which are for sale at low prices and in restricted quantities, and the money income which would like to buy more of these commodities, increases. An ever-growing amount of purchasing power remains idle. If this pressure is permitted to rise too high, and if the controlling powers of the government are not strong enough, the repressed inflation will erupt in open inflation (via black markets).

After a period of repressed inflation it may become necessary to burn up the excess purchasing power which has been accumulating and to close the inflationary gap through price inflation. Another method, used by several countries after World War II, consists of removing the excess purchasing power by blocking existing money reserves and converting old money into new money at some chosen ratio. After such drastic methods have been employed, a totally new pattern of relative prices will have to emerge, under the influence of market forces, to replace the obsolete pattern of controlled prices.

We must come to the conclusion that employment policies in capitalism must not be permitted to lead to a situation in which price-and-production controls become imperative. The history of the period after World War II has given us interesting examples of the dangers of a fiscal policy which is forgetful of these limitations. However, the rediscovery of monetary policies in the early fifties has made it clear that fiscal policies can work successfully in a market economy.

The Public Debt

One more problem—the growth of the public debt—remains to be discussed in connection with deficit spending. Is a growing national debt a danger for the capitalist economy? Does it lead to inflation or burden the economy so much that it will stifle the private enterprise system?

The dangers of a growing public debt have generally been overstated. The major fear seems to be that the debt will, at some future date, have to be repaid and that this will put a heavy burden on our future. Taxes will weigh more and more on the private sector of the economy. Finally, when the limit of taxation is reached, the government will have to revert to inflationary means in financing the debt service.

There are several points which this pessimistic attitude fails to consider.

(1) The amount of debt should always be considered in comparison

with the size of the national income If the policy of deficit spending lifts the national income to a higher level than would otherwise prevail, if it helps to employ factors of production which would otherwise remain idle, the debt is really no burden at all

(2) An increasing debt is not in itself inflationary Whether it is or not depends, as we have seen, on the methods of financing and on the economic conditions prevailing at the time

(3) Taxes which are used to pay interest on the debt go right back to the taxpayers as a group The transfer of income from taxpayer to bondholder may influence the economy favorably or unfavorably, depending on the circumstances, but a domestic debt does not burden the people as a whole

(4) The public debt may be reduced (as in the case of countercyclical spending), but it does not have to be paid off As a matter of fact, its repayment could prove to be most inconvenient for security holders and dangerous for the economy as a whole, since it could cause either inflation or deflation, depending on the prevailing circumstances

From the end of the war until March, 1951, the public debt exerted a strong inflationary pressure in the United States because of a dangerous case of price fixing It was argued that security prices had to be pegged and the pattern of interest rates thus maintained (1) to keep the cost of the debt service low, (2) to protect security holders against a fall in security prices, and (3) to stimulate private investment The Federal Reserve Banks stood ready to absorb with newly created money the securities that could not be sold at the pegged rates This meant that the monetary authority had abdicated the right to regulate the money supply according to any other criteria The result was price inflation

We meet here with a case of price fixing which is particularly dangerous because the credit market is the only market on which the supply can be artificially increased—with inflationary consequences

Were the above mentioned aims worth the enormous price of a complete abandonment of monetary policy? Certainly not Price inflation meant that the government had to pay more for all its purchases, security holders, too, suffered from price inflation (which particularly hurts creditors), and the stimulation of private investment should certainly not have been entrusted to rates of interest which had become frozen many years ago We need, not "low," but correctly chosen rates of interest

The pegging of security prices from 1946 to 1951 is a classic example of a price fixing policy which is incompatible with a market economy in peacetime Moreover, this policy was not able even to achieve the narrower aims which it set out to accomplish

PART THREE

MARXIAN ECONOMICS

CHAPTER 10

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MARXIAN ECONOMICS: AN OUTLINE

The Importance of Marxian Economics

Marxism is not a theory of socialism, which we study to inform ourselves about the socialist economy. Marx says surprisingly little about the economic system which is to follow capitalism. His theory deals mainly with capitalism; more precisely, Marx wanted to study the specific historical character of capitalism as a social system which follows feudalism and precedes socialism. Marx was interested in the process of social change. He tried to show how capitalism, having fulfilled its historic mission to accumulate capital and to develop new productive techniques, turns into a fetter of production. Then follows a social revolution out of which socialism emerges by necessity.

Unfortunately, this historical approach to the problems of capitalism and socialism discouraged "any inquiry into the actual organization and working of the socialist society of the future. If the change was to be brought about by the inexorable logic of history, if it was the inevitable result of evolution, there was little need for knowing in detail what exactly the new society would be like." [1] Thus, if we find the economic theory of socialism completely undeveloped even as late as 1917-1918, we must blame Marx more than anybody else for this serious state of affairs.

We shall study Marx's economic theories, at least in broad outlines, for the following reasons:

(1) Marx was by far the most powerful of all critics of capitalism. It is advisable, therefore, that we follow our discussion of capitalism by a discussion of Marx's impassionate challenge.

(2) Millions have accepted Marxism as gospel truth and have embraced

[1] F. A. Hayek, *Collectivist Economic Planning* (London: George Routledge & Sons, Ltd., and Kegan, Paul, Trench, Trubner & Co., Ltd., 1935), p. 13.

it as a religion "which promises paradise on this side of the grave."[2] This fact alone makes it imperative that the student of economic systems know what Marx believed

(3) Often we cannot interpret socialist writings without a knowledge of Marxian theory Soviet Russian statements, for instance, are frequently clad in Marxian terminology and cannot be understood by those who are ignorant of Marx's economic interpretation of history

(4) Marx s critique of capitalism, though wrong and contradictory, is an absorbingly interesting attempt to see capitalism as a passing phase of economic development and not merely as a given state of affairs which is not likely to change

(5) Marx s theory, when accepted, makes it impossible to believe in any long run improvement of the capitalist system Orthodox Marxists therefore must be basically hostile to capitalism Only revolution, not evolution, can be successful This belief is incompatible with peaceful reforms and perhaps also with a peaceful coexistence of capitalist and Marxist systems Their faith may, however, induce Marxists to wait for the end of capitalism rather than try to bring about its fall by force of arms

(6) Marxism was an understandable reaction against the way in which orthodox classical economics had drained off all specific social content from economic theory[3] Against a conceptual apparatus constructed "to transcend any particular set of social relations"[4] Marx's theory of class struggle seemed realistic, even though it is wrong in its assumptions and conclusions

(7) Marx's description of capitalism as a process of industrial change throws light on certain features of capitalism which tended to be neglected in the classical picture The concentration of economic power, the deficiency of total demand, unemployment, the periodic crises—all these phenomena were considered earlier by Marx than in orthodox classical literature, and they were better integrated by Marx than in contemporary socialist writings

(8) Joan Robinson points out that, while orthodox economists argued in terms of harmony of interests, Marx "conceives of economic life in terms of a conflict of interests between owners of property who do not work and workers who own no property "[5] Even if we grant that there was more logic in the old harmonistic viewpoint than in Marx's theory of the class struggle, Marx may nevertheless be read with some advantage by

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[2] Joseph A Schumpeter, *Capitalism Socialism, and Democracy* (New York Harper & Brothers, 1942), p 5

[3] See Paul M Sweezy, *The Theory of Capitalist Development* (New York Oxford University Press 1942), p 5 Copyright 1942 by Oxford University Press

[4] *Ibid*

[5] Joan Robinson *An Essay on Marxian Economics* (London Macmillan & Co Ltd., 1947), p 1

those who were brought up on too heavy a diet of the classical idea of a general harmony of interests.

The Economic Interpretation of History

In his preface to *The Critique of Political Economy* Marx briefly describes the general conclusion at which he arrived and which "once reached, continued to serve as the leading thread" in his future studies:

> In the social production which men carry on they enter into definite relations that are independent of their will; these relations of production correspond to a definite stage of development of their material powers of production. The sum total of these relations of production constitutes the economic structure of society—the real foundation on which rise legal and political superstructures and to which correspond definite forms of social consciousness. The mode of production in material life determines the general character of the social, political, and spiritual processes of life. It is not the consciousness of men that determines their existence, but, on the contrary, their social existence determines their consciousness. At a certain stage of their development, the material forces of production in society come in conflict with the existing relations of production, or—what is but a legal expression for the same thing—with the property relations within which they had been at work before. From forms of development of the forces of production these relations turn into their fetters. Then comes the period of social revolution. With the change of the economic foundation the entire immense superstructure is more or less rapidly transformed.[6]

This economic interpretation of history must not be too narrowly interpreted.[7] It says neither that the technique of production determines everything else nor that men are exclusively motivated by economic considerations. We must emphasize the concept "mode of production" and understand that Marx interpreted this term rather broadly. The technique of production is important for Marx, but so, too, are the exchange relations. The most characteristic feature of the mode of production in capitalism is seen to be the relation of wage labor to capital, a relation between two—the only two—social classes. This relation expresses itself in the form of exchanges, and exchange therefore is as important as the technique of production. The sum of these relations of production and exchange constitutes the economic structure of society. This economic structure forms, in turn, the real foundation on which rise legal and political superstructures.

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[6] Karl Marx, *A Contribution to the Critique of Political Economy* (Chicago: Charles H. Kerr & Company, 1911), Preface.

[7] Schumpeter, *op. cit.*, pp. 10-13.

These superstructures are very significant for Marx They are not an automatic and instantaneous expression of the underlying mode of production, they can, indeed, become fetters of production Social evolution is seen by Marx to arise out of the conflict between the changing material forces of production and the existing and unyielding relations of production When existing property rights become fetters of production, they must be changed But they do not change automatically and passively with each change in the technique of production Although impeded by the existing legal and political superstructure, the change of the entire social system must inexorably come once the material forces of production have undergone a basic change

Bourgeoisie and Proletariat

The following formulations are mostly verbatim quotations from the *Communist Manifesto* written by Karl Marx and Friedrich Engels in 1848[8]

The most significant and characteristic feature of capitalism is the relation between wage labor and capital, between proletariat and bourgeoisie By bourgeoisie is meant the class of modern capitalists, the owners of the material means of production and employers of wage labor The proletarians, the modern wage laborers, have no means of production of their own and are reduced to selling their labor power in order to live (321)

Bourgeoisie and proletariat are the product of capitalism Feudalism had to decline when its relations of production no longer corresponded to the forces of production The feudal system of industry became inadequate for the growing wants of new colonial markets and the new developments in commerce navigation, and industry, division of labor between the different corporate guilds vanished in the face of division of labor in a single workshop—the manufacturing system (322) With ever growing markets, even manufacture no longer sufficed Steam and machinery revolutionized industrial production The place of manufacture was taken by the giant, modern industry, the place of the industrial middle class, by industrial millionaires, who were leaders of whole industrial armies, the modern bourgeoisie (322)

The bourgeoisie has performed marvels of productivity It has been first to show what man's activity can bring about It has accomplished wonders far surpassing Egyptian pyramids, Roman aqueducts, and Gothic cathedrals It has constantly revolutionized the instruments of production and thereby the relations of production

But in revolutionizing the relations of production the bourgeoisie started a development which will eventually put an end to bourgeois society When

[8] Page numbers in parentheses in the text refer to *Capital the Communist Manifesto and Other Writings by Karl Marx* (New York The Modern Library Inc 1932)

the feudal relations of property became no longer compatible with the already developed productive forces, they became so many fetters; they had to burst asunder; they were burst asunder (326). A similar development is going on before our eyes. Modern bourgeois society, that has conjured up such gigantic means of production, is like the sorcerer who is no longer able to control the powers of the nether world whom he has called up by his spells. The history of industry and commerce is but the history of the revolt of modern productive forces against modern conditions of production, against the property relations that are the condition for the existence of the bourgeoisie and of its rule. Bourgeois society is put on trial, each time more threateningly, through the periodical return of commercial crises (327).

The weapons with which the bourgeoisie felled feudalism to the ground are now turned against the bourgeoisie itself. The bourgeoisie has called into existence the men who are to wield those weapons—the modern working class, the proletarians (328). This is a class of laborers who live only so long as they find work and who find work only so long as their labor increases capital. Exposed to all the fluctuations of the market, their wages are restricted almost entirely to the means of subsistence that they require for the propagation of their race (328).

Bourgeoisie and proletariat are eventually the only two classes left to face each other.[9] Society is more and more splitting up into two great hostile camps (322). The bourgeoisie has put an end to all feudal, patriarchal, idyllic relations and has left no other nexus between man and man than naked self-interest, than callous "cash payment" (323).

With the development of industry not only does the proletariat increase in number (because the lower strata of the middle class all sink gradually into it); it becomes better organized, its strength grows, and it feels that strength more. The workers form trade-unions, and while these trade-unions are only now and then temporarily successful, the real fruit of the battle lies not in immediate results but in the ever-expanding union of workers (330). The advance of industry, whose involuntary promoter is the bourgeoisie, ends the isolation of the laborers due to competition. It instead facilitates their combination due to association. The development of modern industry, therefore, cuts from under the feet of the bourgeoisie the very foundations on which this class produces and exploits. The bourgeoisie produces, above all, its own gravediggers. Its fall and the victory of the proletariat are equally inevitable (334).

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[9] ". . . it was a bold stroke of analytical strategy which linked the fate of the class phenomenon with the fate of capitalism in such a way that socialism, which in reality has nothing to do with the presence or absence of social classes, became, by definition, the only possible kind of classless society, excepting primitive groups. This ingenious tautology could not equally well have been secured by any definitions of classes *and* of capitalism other than those chosen by Marx—the definition by private ownership of means of production."—Schumpeter, *op. cit.*, p. 19.

These quotations from the *Communist Manifesto* provide us with the necessary framework for a study of Marx's economic theories. Here we see set forth, long before the publication of *Capital*, Marx's general beliefs and intentions. We see what he wanted to prove. He wanted to show not only that the whole capitalist process is one gigantic exploitation of one class by another, but also that the logic of this process of capitalist development must lead inexorably to a future classless society.

An Outline of Marxian Economics

For the better understanding of Marxian economics it is important that we be at all times aware of the relation of each part of the analysis to the whole. For this reason we shall first draw a rough sketch of the Marxian edifice without any attempt to criticize Marx's assumptions, definitions, and conclusions. Although it will not be our intention to emphasize at this time the inconsistencies within the Marxian scheme, they may be apparent to the reader even in this rough sketch. A first survey of this sort serves merely as a map to aid us in seeing, later on, what significance these earlier steps of Marx's analysis have for the conclusions which he draws. Since our outline is immediately followed by a fuller and more critical treatment, axiomatic formulations seem permissible.

(1) THE LABOR THEORY OF VALUE. Commodities are products of human labor which are produced for the market. When two different commodities are exchanged, one for the other, they have this in common: they are both the product of the same amount of abstract human labor.

(2) SOCIALLY NECESSARY LABOR. In determining the exchange value of a commodity, only socially necessary labor counts. Labor is socially necessary when it is of average skill and intensity, uses modern instruments of production, and produces a commodity which is in demand. Skilled labor is a multiple of average labor. Not only "present" labor is socially necessary, but also "past" labor, that is, labor needed to produce the raw materials and the machines used in the production of our commodity.

(3) THE VALUE OF LABOR POWER. The exchange value of labor power itself is determined (like the exchange value of commodities) by the labor time needed for production of the means of subsistence of the laborer.

(4) SURPLUS VALUE. The laborer, who does not own the means of production, sells his labor power to the capitalist, who pays a wage equal to the value of labor power. He pays, for instance, a wage

equal to 6 labor hours, if 6 labor hours are needed to produce the daily sustenance for the laborer. But the capitalist has bought the whole day's labor power (say, 12 hours of labor power). The exchange value of the commodities produced by the laborer is, therefore. equal to 12 labor hours. We see that the laborer produces 6 hours' worth of commodities over and above the commodities which are needed to cover his means of subsistence. This is the surplus value, which the capitalist keeps for himself.

(5) CONSTANT CAPITAL AND VARIABLE CAPITAL. The value of a commodity consists of three parts: constant capital, variable capital, and surplus value. Constant capital (c) is the value of whatever part of the machinery is used up in the production process (depreciation) and of the raw materials. This part of a commodity's value is called constant capital because it remains constant and does not produce surplus value for the capitalist. Variable capital (v) is the value of labor power used; it is called variable capital because it *produces surplus value* (s). The total value of a commodity equals $c + v + s$. We see that total capital is divided into two parts, c and v, of which only v produces s.

(6) THE RATE OF SURPLUS VALUE. The rate of surplus value, also called *the rate of exploitation,* is the ratio of surplus value to variable capital (s/v). A part of the whole labor day is needed to produce the means of subsistence for the laborer. If this part is assumed to be 6 hours, although the laborer works a total of 12 hours, the rate of exploitation s/v is 6/6, or 100 per cent.

(7) THE ORGANIC COMPOSITION OF CAPITAL. The organic composition of capital is the ratio of constant capital to variable capital (c/v). It can also be expressed as $c/c + v$, the ratio of constant capital to total capital. The organic composition of capital, owing to technological advance, undergoes a continuous change in favor of constant capital.

(8) THE RATE OF PROFIT. The rate of profit is the ratio of surplus value to total capital: $s/c + v$. It is determined by the rate of exploitation s/v and by the organic composition of capital c/v.

(9) THE FALLING RATE OF PROFIT. Since the organic composition of capital undergoes a continuous change in favor of constant capital, the rate of profit must have the tendency to fall, because only the variable part of total capital produces surplus value.

(10) THE EFFECT OF MACHINERY ON THE RATE OF SURPLUS VALUE. The increased use of machinery increases the rate of exploitation, because it now takes less time to produce a laborer's means of subsistence; besides, these means can now be earned by several members of the laborer's family, because the machine permits the use of laborers of slight muscular strength. It also becomes possible to lengthen

the labor day and/or to increase the intensity of work When the rate of surplus value increases, the rate of profit tends to rise

(11) THE RESERVE ARMY OF LABOR The most important effect of machinery is to make a portion of the labor class superfluous, to create a reserve army of unemployed men and to exert a continuous downward pressure on wages The reserve army is also called the relative surplus population

(12) THE EQUALIZATION OF THE RATE OF PROFIT. Since the organic composition of capital differs from industry to industry, the rate of profit $(s/c + v)$ must also differ But the rate of profit tends, nevertheless, to be equal throughout the economy Firms will leave low-profit industries (which have a "high" organic composition of capital) and enter high-profit industries (with a "low" organic composition of capital) Finally, all capitalists will receive an average rate of profit according to the size of their capital $(c + v)$ The price of commodities now differs from the value of commodities, because the s in $c + v + s$ has been replaced by an average s for all industries

(13) EQUALIZATION OF THE RATE OF EXPLOITATION Competition among laborers, their movement from industry to industry, makes the rate of surplus value the same everywhere

(14) THE ANTAGONISTIC CONDITIONS OF DISTRIBUTION The antagonistic conditions of distribution reduce the consuming power of the masses to a minimum The productive power of the economy finds itself at variance with this narrow basis of consumption

(15) PERIODICAL CRISES The fall of the rate of profit and the growth of the reserve army are periodically interrupted A crisis eliminates the smaller capitalists, concentrates capital in fewer hands and lowers the value of constant capital Furthermore, the reserve army grows during a crisis, and the increased rate of exploitation raises profits for the surviving capitalists Then follows a period of increased accumulation and increased demand for labor power But rising wages cut again into the surplus value This explains the phenomenon that crises are preceded by high rather than by low wages

(16) IMMISERIZATION[10] AND BREAKDOWN Since the commercial crises are superimposed on a downward trend, they return each time more threateningly Real wages and the standard of living must fall (immiserization) as the capitalist class shrinks (concentration) and the proletariat grows The existing property relations (the antagonistic conditions of distribution) turn into such fetters of production that social revolution will finally usher in the classless society

[10] This is Schumpeter's suggestion for the proper translation of the Marxian concept *Verelendung Ibid*, p 34

CHAPTER 11

MARXIAN ECONOMICS: THE THEORY OF SURPLUS VALUE

Ricardo's Labor Theory of Value

Marx wanted to show that the capitalist process is a process of exploitation of one class by another and that the economic consequences of this exploitation will eventually destroy capitalism.

The economic theory which explains this process of exploitation is the theory of surplus value which, in turn, rests on the labor theory of value. Because of its fundamental importance we have to study Marx's labor theory of value carefully. We shall see that it is untenable and that Marx himself had to discard it in the end.

Marx's attitude can be understood much better after a brief review of David Ricardo's labor theory of value, which had a profound influence on Marx. In the preface to his *Principles of Political Economy and Taxation*[1] Ricardo says that the principal problem in political economy is to determine the proportions of the whole produce of the earth which will be allotted to the different classes in the form of rent, profit, and wages. This starting point leads him directly into the theory of exchange value. After having said that utility is not the measure of exchangeable value, although it is absolutely essential to it, Ricardo makes a statement which was to influence the development of economic theory for generations: "Possessing utility," he writes, "commodities derive their exchangeable value from two sources: from their scarcity, and from the quantity of labor required to obtain them."[2]

This statement contains a basic mistake. Reference to scarcity would have been correct and enough; reference to the quantity of labor led

[1] *The Works of David Ricardo,* ed. J. R. McCulloch (London: McCulloch, 1846).
[2] *Ibid.,* p. 9.

Ricardo (and Marx) into a labor theory of value which was unnecessary, awkward, and wrong Why did Ricardo believe that he had to add this reference to the quantity of labor?

Ricardo admitted that there are some commodities whose value is determined by scarcity alone (such as rare books and coins, or wines of peculiar quality) because no labor can increase their quantity, but he points out that these commodities form a very small part of the mass of commodities daily exchanged in the market "By far the greatest part of those goods which are the objects of desire, are procured by labor, and they may be multiplied almost without any assignable limit, if we are disposed to bestow the labor necessary to obtain them" [3] Ricardo obviously felt that the principle of scarcity did not apply to these products of labor and that another principle for the determination of their value had to be found This principle, he believed, was the quantity of labor required for the production of commodities whose production could be increased "almost without any assignable limit "

Ricardo was wrong We can, of course, produce more shoes or more shirts, but we cannot (at full employment) increase the production of all commodities "almost without limit' Expansion of one industry requires, as a rule, the contraction of another To solve the problem of exchange value, the principle of scarcity should have been applied to the factors of production rather than to individual products On this basis a general theory of prices could have been worked out We have already studied the modern version of this theory in Chapter 3

Ricardo acknowledged the existence of three factors of production labor, land, and capital. How could he then maintain that commodities are exchanged according to used up labor alone? How, furthermore, did he account for different kinds of labor which have different exchange values?

(1) Ricardo excluded the influence of the factor land by assuming that the price of commodities is determined on marginal land which is free The owner of better-than-marginal land receives a rent, to be sure, but the price of the product produced on marginal land determines the rent, and not the other way round, i e , the rent does not influence the price

(2) As far as the factor capital is concerned, Ricardo simply assumes that capital and labor are always employed in the same proportion We shall meet this same argument again in the discussion of Marx's concept of the organic composition of capital For Marx, too, it is essential to assume a uniform proportion of constant and variable capital throughout the economy if the rate of profit is to be equal in different industries and if the value theory of labor is to be maintained

(3) Concerning the problem of different kinds of labor, Ricardo merely states that "the estimation in which different qualities of labor are held,

[3] *Ibid.*, p 10

comes soon to be adjusted in the market with sufficient precision for all practical purposes, and depends much on the comparative skill of the laborer, and intensity of the labor performed."[4] Since this estimation of the market obviously depends on the exchange value of the product which a given kind of labor is able to produce, Ricardo is guilty of circular reasoning. He wants to explain the exchange value of commodities via the quantity of labor, but needs the value of the commodities to reduce different kinds of labor to normal labor. "He completely overlooks that in arguing in this way he appeals to another principle of valuation and really surrenders the labor-quantity principle which thus fails from the start, within its own precincts, and before it has the chance to fail because of the presence of factors other than labor."[5]

We shall see that Marx is caught in the same dilemma.

Ricardo's labor theory of value was a misconception. But it appealed to Marx because it emphasized the factor labor so much more than a general price theory would have done. As we change now to Marx's labor theory of value, we must keep in mind that Marx goes much further than Ricardo. Where Ricardo suggested that goods exchange *in proportion to* the labor used in their production, Marx considers labor *the substance of* value.

Marx's Labor Theory of Value

Marx begins his labor theory of value with an analysis of the commodity because "the wealth of those societies in which the capitalist mode of production prevails, presents itself as 'an immense accumulation of commodities'" (I,41).[6] He defines the commodity as an article which has utility, is the product of human labor, and is produced for the market. We note how narrow this definition is. Since the commodity must be the product of human labor, Marx excludes from commodities such gifts of nature as the soil, wood in trees, water power, coal beds, etc., just as Ricardo excluded all goods whose quantity could not be increased by labor.[7] These gifts of nature command exchange value; an explanation of exchange value which is not able to account for them is inadequate.

Marx argues that because, as use values, commodities are of different

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[4] *Ibid.*, p. 15.

[5] Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper & Brothers, 1942), p. 24.

[6] Volume and page numbers in parentheses refer to Karl Marx, *Capital, A Critique of Political Economy*, Vol. I, *The Process of Capitalist Production;* Vol. II, *The Process of Circulation of Capital;* Vol. III, *The Process of Capitalist Production as a Whole* (Chicago: Charles H. Kerr & Company, 1906, 1909, 1909).

[7] See Eugen von Böhm-Bawerk, *Karl Marx and the Close of His System* (New York: The Macmillan Company, 1898), p. 135.

qualities, the exchange value cannot contain "an atom of use-value" (I,44), then follows a completely uncalled for conclusion "If then we leave out of consideration the use-value of commodities, they have only one common property left, that of being products of labor" (I,44)

There are, of course, other qualities which commodities have in common for instance, that they are all scarce or that they are all products of scarce factors of production, though not necessarily of labor alone Emphasis on scarcity would have permitted the inclusion of the categories of commodities which Ricardo and Marx had to eliminate, viz, those whose scarcity is obviously not determined by the labor which went into their production

In first defining commodities as products of labor and then saying that commodities had only one common property left, that of being the products of labor, Marx acts like a man "who urgently desiring to bring a white ball out of an urn takes care to secure this result by putting in white balls only" [8]

Why did Marx ignore the obvious fact that commodities which were not the product of labor had exchange value, and that those which were made by labor exchanged at ratios permanently diverging from the ratio of labor contained in them? Why did he not discard the whole labor theory of value with its embarrassing contradiction of obvious facts?

Marx was a disciple of Ricardo, and it is not surprising that he was not too skeptical of a view which was so well designed to support his own preconceived economic theory Marx needed the labor theory of value as a basis for the theory of surplus value, he needed it to prove the existence of exploitation and all the rest, he needed it to keep "insistently before the mind of the reader a picture of the capitalist process as a system of piracy, preying upon the very life of the workers" [9]

Marx did not realize that the labor theory of value is quite unnecessary to support a conviction that capitalism is essentially a system of exploitation It is "an unfounded dogma that, unless we go in for all this rigmarole about 'value,' we cannot say that capitalists get part of the social product without working" [10]

That the problem of exchange value could be discussed quite realistically, without prejudice to the social justice of the outcome, had already been indicated by Adam Smith "In that original state of things," Smith wrote, "which precedes both the appropriation of land and the accumula-

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[8] *Ibid* p 134

[9] Joan Robinson *An Essay on Marxian Economics* (London Macmillan & Co Ltd, 1947), p 22

[10] Abba P Lerner, "Marxism and Economics Sweezy and Robinson" *Journal of Political Economy* LIII (March 1945), 81 Modern economists know how to distinguish between 'personal and "functional" distribution of income and they also know that the connection which exists between the two in capitalism can be dissolved under different, that is noncapitalist arrangements

tion of stock, the whole produce of labor belongs to the laborer." Then he goes on to show how, as soon as land becomes private property, the landlord's rent "makes the first deduction from the produce of the labor which is employed upon land" and how the capitalist's profit "makes a second deduction" from the produce of labor. Both the landlord and the capitalist are able to extract their share because they are in the bargaining position to do so. "A landlord, a farmer, a master manufacturer, or merchant, though they did not employ a single workman, could generally live a year or two upon the stocks which they have already acquired. Many workmen could not subsist a week, few could subsist a month, and scarce any a year without employment." [11]

Adam Smith's approach shows that Marx could have accepted the determination of commodity prices according to the relative scarcity of the different factors of production which went into the production of these commodities and still have protested against the income distribution which is characteristic of capitalism.

Marx's assertion that the exchange value of commodities is determined by the only property common to all, viz., abstract human labor, is entirely arbitrary. Its fallacy is revealed by even the most superficial observation of how prices are actually determined on the real markets of the capitalist economy. Nowhere do commodities exchange according to the amount of abstract human labor contained in them. The exchange value of commodities is determined by conditions of demand and supply and, in equilibrium, by production costs, provided that the commodities in question are the result of production. Production costs do not consist of wages alone; they consist of anything which is needed, is scarce, and commands a price. Labor itself is a factor supplied in an infinite variety of qualities, reducible to "abstract human labor" only by market forces, as we shall presently see.

Regarding the influence of demand upon the exchange value of commodities, Marx wavers somewhat between the statement that exchange value does "not contain an atom of use-value" (I,44) and the admission that "in order that a commodity may be sold at its market-value, that is to say, in proportion to the necessary social labor contained in it, the total quantity of social labor devoted to the total mass of this kind of commodities must correspond to the quantity of the social demand for them, meaning the solvent social demand" (III, 226-227).

We see that Marx, like Ricardo, returns to market conditions of supply and demand whenever his labor theory of value offers no solution.

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[11] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. E. Cannan (London: Methuen & Co. Ltd., 1925), I, 66-68.

Socially Necessary Labor Time

In elaborating his basic postulate, that the exchange value of a commodity depends on the human labor embodied in it, Marx points out that only socially necessary labor may be counted To find the socially necessary labor time for an article, the following points have to be considered

(1) The socially necessary labor time is the time spent by labor possessing average skill and working with average intensity Skilled labor has to be reduced to average labor

(2) Normal conditions of production must be given Labor must be supported by modern machinery Today, for instance, it would be labor done with the bulldozer and not with the hand shovel

(3) The product must be in demand Labor could not be counted as socially necessary if too much of its product has been produced in relation to solvent social demand

(4) The labor time to be counted includes "past' as well as "present" labor Past labor is the labor which went into the raw materials and into what Marx calls the ' wasted ' or ' used up ' portion of the machinery

We shall now discuss these four characteristics of socially necessary labor

In the reduction of skilled labor to normal labor Marx meets the same difficulties which Ricardo had to face, and like Ricardo, he suggests that these difficulties are solved by the market We are told

> skilled labor counts only as simple labor intensified, or rather, as multiplied simple labor, a given quantity of skilled labor being considered equal to a greater quantity of simple labor Experience shows that this reduction is constantly being made The different proportions, in which different sorts of labor are reduced to unskilled labor as their standard, are established by a social process that goes on behind the backs of the producers, and, consequently, appear to be fixed by custom (I, 51 52)

This is the same circular reasoning of which Ricardo was guilty Marx sets out to show that the exchange value of commodities is determined by the amount of abstract human labor contained in them Then, in reducing different kinds of labor to abstract labor, Marx simply refers to the social process which determines, via the exchange value of the commodities, the exchange value of different kinds of labor

Marx illustrates the "normal conditions of production" by the following example If the capitalist should "have a hobby, and use a gold instead of a steel spindle, yet the only labor that counts for anything in the value of the yarn is that which would be required to produce a steel spindle, be-

cause no more is necessary under the given social conditions" (I,210).

It is very important to stress this point in the Marxian system: once a new machine is introduced, the working time which is considered socially necessary is the working time of a man equipped with the new machine. This fact explains why the capitalist will not necessarily invest in variable capital rather than in constant capital, in spite of Marx's finding that only variable capital produces surplus value.

In defining socially necessary labor Marx insists that there must be enough solvent social demand for the product. If more of a commodity has been produced than can be sold at a price which corresponds to the socially necessary labor time, production must be contracted; on the other hand, if the exchange value of the product exceeds the value of abstract human labor contained in it, production must be expanded. Speaking of the labor of a weaver, Marx points out that "if the community's want of linen . . . should already be saturated by the products of rival weavers, our friend's product is superfluous, redundant, and consequently useless. . . . If the market cannot stomach the whole quantity at the normal price of 2 shillings a yard, this proves that too great a portion of the total labor of the community has been expended in the form of weaving" (I, 120). In the light of these comments Marx can no longer maintain that the exchange value does "not contain an atom of use-value" (I, 44).

Here we find Marx again in the closest neighborhood of the theory of supply and demand. That Marx did not pursue this argument, or did so only apologetically in Volume III of *Capital,* is obviously due to the fact that the argument endangers the labor theory of value. The exchange value of labor must not be derived from the exchange value of its product if the labor theory of value and the theory of surplus value are to be maintained. As soon as the relative scarcity of the product and of the factors of production are admitted as determining factors, the whole labor theory of value becomes superfluous and is exposed as an excessively weak foundation of the theory of capitalist development.

Materials and machines are the product of labor and "transfer value to the new product, so far only as during the labor-process they lose value in the shape of their old use-value" (I,229). "The whole of the labor in the yarn is past labor; and it is a matter of no importance that the operations necessary for the production of its constituent elements were carried on at times which, referred to the present, are more remote than the final operation of spinning" (I,209).

We note here that capital goods are considered merely so much past labor and that Marx denies that they can transfer more value to products than corresponds to their own production costs in terms of socially necessary labor time. This means that Marx denies that capital goods are value-producing, that they are characterized by a special scarcity which raises the price of their products over and above the cost of past and present la-

bor In other words, Marx denies the existence of that special problem which the theory of interest explains

The Value of Labor Power

Since the surplus value is the difference between the value of the product of labor (which belongs to the capitalist who bought the labor power) and the value of labor power (the price paid by the capitalist for labor power), it is necessary that we should inquire into the determination of the value of labor power

According to Marx, "the value of labor power is determined, as in the case of every other commodity, by the labor time necessary for the production, and consequently also the reproduction, of this special article in other words, the value of labor-power is the value of the means of subsistence necessary for the maintenance of the laborer" (I,189-190) Marx insists that labor power is a commodity like every other commodity We remember that he defined a commodity as an article which has utility, is the product of labor, and is produced for the market In capitalism labor is not produced for the market, as it might be in a society of slave owners, and it is, therefore, quite unjustified that Marx applies the laws which determine the value of commodities to the "commodity," labor power

The necessary means of subsistence are to be understood as a cultural rather than a physical minimum, and they must include the means necessary to bring up the laborer's replacements, his children, in order that this peculiar commodity may perpetuate its appearance in the market (I,191) Likewise included in the value of labor power are the costs involved in learning the skill and dexterity requisite for a given branch of labor

But why is labor condemned to subsist permanently on the minimum of existence? Why is labor continuously exploited?

The laborer, according to Marx, is "free in the double sense, that as a free man he can dispose of his labor power as his own commodity, and that on the other hand, he has no other commodity for sale, is short of everything necessary for the realization of his labor power" (I, 187-188) "Marx s idea is that there is no essential difference, though there are many secondary ones, between the wage contract and the purchase of a slave—what the employer of 'free' labor buys is not indeed, as in the case of slavery, the laborers themselves but a definite quota of the sum total of their potential labor " [12]

Marx obviously wants to show that the labor market is a buyer's market where labor, lacking the essential material means of production, has to sell itself at any price offered, as long as the price is just high enough to permit labor's own reproduction

[12] Schumpeter, *op cit*, p 26

This pessimistic conclusion was well known in Marx's time and therefore easily accepted by his readers. In his *Essay on the Principle of Population,* written in 1798, Robert Malthus had taught that population tends to increase, when unchecked, in a geometric progression, whereas the supply of food increases at best in arithmetic progression. When more capital and labor are applied to a given piece of land, the law of diminishing returns makes itself felt. Population, therefore, will eternally press upon the means of subsistence, and wages can only temporarily exceed the minimum needed for existence. If wages are higher than this, population will grow, real wages will fall, and famine and pestilence will reduce the population once more to the number which is able to subsist.

Marx never accepted the Malthusian doctrine. Referring to Ferdinand Lassalle's "iron law of wages," he declared,

> If I take the law with Lassalle's stamp and, therefore, in his meaning, then I have to take it also with his explanation. And what is this explanation? The Malthusian population theory. However, if this theory is correct, then again I cannot abolish the law even if I abolish wage-labor a hundred times, because then the law rules not only the system of wage-labor but any social system.[13]

A *natural* law clearly was not acceptable to Marx.

Marx relies instead on the capitalist relation and on the reserve army. The capitalist relation is the relation between the capitalist who owns the instruments of production and the wage laborer who owns nothing but his labor power.

> Capitalist production . . . of itself reproduces the separation between labor-power and the means of labor. It thereby reproduces and perpetuates the condition for exploiting the laborer. It incessantly forces him to sell his labor-power in order to live, and enables the capitalist to purchase labor-power in order that he may enrich himself. It is no longer a mere accident that capitalist and laborer confront each other in the market as buyer and seller. It is the process itself that incessantly hurls back the laborer onto the market as a vendor of his labor-power, and that incessantly converts his own product into a means by which another man can purchase him (I,632-633).

This argument is not convincing. Although it is true that the laborer has to sell his labor power, it is equally true that the capitalist has to buy labor power in order to make use of his machinery. That many laborers face few capitalists and that the laborer, as a rule, lacks private means, are important facts; but they are not sufficient to establish another "iron law of wages."

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[13] Karl Marx, *Kritik des Gothaer Programms* (Berlin: Dietz Verlag, 1955), p. 29.

As Eduard Heimann puts it, Marx's theory would be faultless only if capital could, if need be, get along without the laborer [14]

Marx needs a stronger argument to prove that the comparative bargaining power of labor is extremely weak He believes that he has found such an argument in the theory of the reserve army, the army of the unemployed, which creates a labor market in which more men are constantly looking for jobs than jobs for men

But even the theory of the reserve army is unable to prove that wages will not rise in the short or in the long run In fact, within the logic of Marx's own theory the following possibilities exist (1) The reserve army may be depleted through capital accumulation In this case wages, relieved of competitive pressure, will rise above the subsistence minimum (2) The law of the equalization of the rate of profit induces industrialists to enter fields of industry which use relatively large amounts of variable capital This tendency increases the demand for labor, and, consequently, wages (3) If the rate of profit tends to fall while efficiency of production increases, wages must rise permanently because labor gets a larger share of an increasing pie

Surplus Value

The theory of surplus value rests on (1) the labor theory of value and (2) the assumption of capitalist production, a social process in which the material means of production are owned by capitalists The capitalist purchases labor power for a wage equal to its value, that is, the value of the means of subsistence required for the reproduction of labor power If it requires half a day s labor to produce the goods and services needed to keep the laborer and his family alive during a twenty four hour period, the capitalist must pay the laborer the product of half a day's labor or its monetary equivalent Once the capitalist has bought a worker's labor power, "the right to use that power for a day belongs to him' (I,206)

> The fact that half a day's labor is necessary to keep the laborer alive during 24 hours, does not in any way prevent him from working a whole day Therefore, the value of labor-power, and the value which that labor power creates in the labor process are two entirely different magnitudes, and this difference of the two values was what the capitalist had in view, when he was purchasing the labor power (I,215-216)

The commodities produced during twelve hours of normal labor are worth twelve hours However, to purchase the work of twelve hours (that is, one

[14] Eduard Heimann, *Soziale Theorie des Kapitalismus* (Tübingen J C B Mohr, 1929), p 15

whole labor day) costs the capitalist in our example a wage equal to the product of only six normal labor hours (half a day's labor). The difference accruing to the capitalist is surplus value equal to six normal labor hours.

It should be noted that Marx does not blame the individual capitalist for the exploitation of labor. "What he wanted to prove was that exploitation did not arise from individual situations occasionally and accidentally; but that it resulted from the very logic of the capitalist system, unavoidably and quite independently of any individual intention." [15]

The reader of *Capital* cannot escape the impression that Marx conceived the idea of surplus value before he worked out his theory. His labor theory of value implies the surplus value. "He knew the result he wished to obtain, and must obtain. and so he twisted and manipulated the patient ideas and logical premises with admirable skill and subtlety until they actually yielded the desired result in a seemingly respectable syllogistic form." [16] Those who have studied Marx's theory of value will find it hard to believe that the theory of surplus value was the result of unbaised research. Marx knew what he wanted to prove. He knew it as early as 1848 when he and Friedrich Engels wrote the *Communist Manifesto.* He wanted to unmask exploitation.

Marx's "terminology derives its force from the moral indignation with which it is saturated." [17] Of this terminology the term "surplus value" was the most powerful and impressive. It had to stand out clearly as the incarnation of everything that was wrong in capitalism, as the source of all evil. Profit, interest, rent—all income that was not earned by labor—merged into one huge gain from exploitation: surplus value.

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[15] Schumpeter, *op. cit.*, p. 26.
[16] Böhm-Bawerk, *op. cit.*, p. 152.
[17] Joan Robinson, *op. cit.*, p. 22.

CHAPTER 12

MARXIAN ECONOMICS: THE THEORY OF PROFIT

Variable Capital and Constant Capital

The capitalist is driven by the profit motive In order to make profit he spends money (M) on labor, transforms labor into commodities (C), and sells these commodities for a larger amount of money (M') The difference between M' and M is the surplus value, the result of exploitation It is attributable to the variable capital alone, i e, to the wages paid for labor This fact accounts for the name "variable" capital, because this part of capital is continually being transformed from a constant into a variable magnitude (I,233) [1]

"Constant" capital, by contrast, "does not undergo any quantitative alteration of value" (I,232) and derives its name from this fact Constant capital consists of materials and machines Marx calls the machines "fixed capital" in contradistinction to "circulating capital' in the form of raw and auxiliary materials The value of these materials is fully imparted to the commodity Fixed capital is not so easily handled Marx does not include in the value of a product more than that part of the instrument which was "wasted" during the process of production, i e, replacement costs 'Suppose a machine to be worth £1,000, and to wear out in 1000 days Then one thousandth part of the value of the machine is daily transferred to the day's product' (I,227)

Marx's statements are correct but incomplete The final product must, of course, pay for past labor in addition to present labor, i e, it must pay

[1] Volume and page numbers in parentheses refer to Karl Marx *Capital A Critique of Political Economy* Vol I *The Process of Capitalist Production* Vol II *The Process of Circulation of Capital* Vol III *The Process of Capitalist Production as a Whole* (Chicago Charles H Kerr & Company, 1906 1909, 1909)

for materials and the replacement cost of machinery used in its production. But this is not all that ought to be counted. The interest on the invested capital ought to enter into the cost calculations, since capital has a specific scarcity and commands a price; but interest is not included by Marx, at least not as a cost factor.

When Marx tries to figure the value of past labor he is not interested in capital as a whole. Wear and tear amount to only a small fraction of the constant capital invested. It is, however, the *total* amount of constant capital which, together with the variable capital, should be used to determine interest as a cost factor. Marx himself uses this concept of total capital in the determination of the rate of profit.

Joan Robinson has pointed out that "both the organic composition of capital and the rate of profit are connected with the stock of capital employed, not with the depreciation of capital."[2] She differentiates stock of capital or total capital, depreciation (d), and raw materials (r). "Then $r + v$ and d must each be multiplied by the appropriate period of turnover. Suppose, for instance, that working capital represents on average six-months outlay on wages and raw materials, and that the average life of plant is ten years. Then $r + v$ must be divided by 2, and d multiplied by 10, in order to reduce $c + v$ to the stock of capital."[3] Marx himself was quite aware of the importance of the rate of turnover, as is shown in Chapters 7 and 8 of Volume II of *Capital*. Some confusion arises, however, because in determining the value of the commodity he is interested in a magnitude different from the one which he has in mind when he discusses the rate of profit, but refers to both magnitudes as total capital.

The value of the commodity is $c + v + s$. In this case c stands for depreciation and materials. The value of the constant capital *used up* is imparted to the value of the product.

Paul M. Sweezy suggests that the formula $c + v + s$ could be extended to take in the entire economy.

> If we use capital letters to designate aggregate quantities, we can say that modern theorists, when they speak of gross national income, commonly include $V + S$ plus that part of C which represents depreciation of fixed capital, but exclude the rest of C. By net national income, they

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[2] Joan Robinson, *An Essay on Marxian Economics* (London: Macmillian & Co. Ltd., 1947), p. 7.

[3] *Ibid.* If the fixed capital has an average life of ten years, only one tenth of it is "wasted" during the year. If we assume depreciation per year to be $10,000, the value of the stock of fixed capital is $100,000. Suppose that, in addition, payments for raw materials and labor ($r + v$) amount to $50,000 per annum. Since one production period is six months, the capital can be used twice within one year, so that a capital *stock* of $25,000 suffices for these payments. In our example, total capital (c) is $125,000; depreciation ($d$), $10,000; and payments for raw materials and wages ($r + v$), $50,000.

mean simply $V + S$, which includes all payments to individuals plus business savings[4]

We note that this aggregation is not an addition of all commodity values To avoid double counting, only products which enter the gross national in come are counted

If $V + S$ is net national income, S/V determines labor's share in the national income, V being the wage payments during the year and S the source of all incomes not derived from wage labor (profit, interest, rent)

The Rate of Exploitation (the Rate of Surplus Value)

Marx explains the rate of surplus value as follows During one portion of the labor day the laborer produces only the value of the means of subsistence which he and his family consume Though he does not directly pro duce these necessaries himself, he produces a product equivalent to them in value 'The portion of his day's labor devoted to this purpose will be greater or less, in proportion to the value of the necessaries that he daily requires on an average, or, what amounts to the same thing, in proportion to the labor-time required on an average to produce them' (I,240) Marx calls this portion of the working day *necessary labor time* "During the second period of the labor-process the workman creates no value for himself He creates surplus-value which, for the capitalist, has all the charms of a creation out of nothing" (I,240) Marx calls the labor time so spent *surplus labor time*

The rate of exploitation, as a division of the labor day into necessary and surplus labor time, is determined by (1) the length of the working day and (2) the time required to produce the means of subsistence for the laborer

In the process which increases the rate of exploitation, machinery plays an important part It "is intended to cheapen commodities, and, by shortening that portion of the working-day, in which the laborer works for himself, to lengthen the other portion that he gives, without an equivalent, to the capitalist" (I,405) The machinery, in short, is "a means for producing surplus value" (I,405)

The machine has the following effects

(1) The machine cheapens the commodities by which labor subsists and thereby reduces the necessary labor time

(2) The machine becomes a means of employing women and children, i e , laborers of slight muscular strength (I,431) This increases the rate of exploitation Not only is the supply of labor power greatly increased, but the necessaries of life for the whole family can now be earned by the com-

[4] Paul M Sweezy, *The Theory of Capitalist Development* (New York Oxford University Press, 1942), p 63 Copyright 1942 by Oxford University Press

bined effort of several members of the family. "In order that the family may live, four people must now, not only labor, but expend surplus-labor for the capitalist" (I,431-432).

(3) The machine lengthens the working day and "the lengthening of the working day . . . allows of production on an extended scale without any alteration in the amount of capital laid out on machinery and buildings. Not only is there, therefore, an increase of surplus-value, but the outlay necessary to obtain it diminishes" (I,442-443).

(4) The machine increases the rapidity and intensity of labor (I,447). This effect will be particularly strong if the labor day should be shortened by social legislation. When the shortening of labor hours becomes compulsory, "machinery becomes in the hands of capital the objective means, systematically employed for squeezing out more labor in a given time. This is effected in two ways: by increasing the speed of the machinery, and by giving the workman more machinery to tend" (I,450).

(5) The machine becomes the competitor of the laborer. "That proportion of the working class, thus by machinery rendered superfluous . . . floods all the more easily accessible branches of industry, swamps the labor market, and sinks the price of labor-power below its value" (I,470).

There is in operation, according to Marx, a "law of the progressive increase in constant capital, in proportion to the variable" (I,682). The capitalist must increase his constant capital because of competitive pressure. We remember that the capitalist cannot hope to gain more surplus value by employing more men through the use of antiquated machinery, since he may count, as socially necessary labor, only labor equipped with modern instruments. A capitalist who cannot increase his constant capital as required by technological progress will soon be unable to compete. Thus he will cease to be a capitalist and will join the ranks of the proletariat. Accumulation therefore will result in the concentration of wealth in fewer and fewer hands.

When the organic composition of capital undergoes a continuous change in favor of constant capital, the mass of the material means of production grows faster than the mass of labor power employed. Suppose that the organic composition of capital c/v changes from 1/1 to 2/1, 3/1, 4/1, etc. As total capital increases, a smaller and smaller proportion of the total is transformed into labor power (I,690). "Since the demand for labor is determined not by the amount of capital as a whole, but by its variable constituent alone, that demand falls progressively with the increase of the total capital" (I,690). "An accelerated accumulation of total capital, accelerated in a constantly growing progression, is needed to absorb an additional number of laborers, or even, on account of the constant metamorphosis of old capital, to keep employed those already functioning" (I,690). Thus, "it is capitalist production itself that constantly produces . . . a relatively redundant population of laborers, i.e., a population of greater extent than suffices for the average needs of the self-expansion of capital, and therefore

a surplus-population" (I,691). This surplus population may take the more striking form of a repulsion of laborers already employed, or the less evident, but not less real, form of more difficult absorption of the additional laboring population through the normal channels (I,691).

The surplus population is Marx's famous industrial reserve army "that belongs to capital quite as absolutely as if the latter had bred it at its own cost" (I,693), that "creates, for the changing needs of the self-expansion of capital, a mass of human material always ready for exploitation" (I,693).

These effects of the machine all work in the same direction—they tend to increase the rate of exploitation. The Marxian system, though, also contains, as we shall see, elements which may explain a tendency toward a lower rate of exploitation. The tendency toward an increasing rate of exploitation seems, at first, to be more consistent in the Marxian scheme. But if the final aim of the Marxian analysis is to prove the eventual downfall of capitalism, mainly in consequence of the tendency toward a lower rate of profit, the increasing rate of exploitation becomes embarrassing. The tendency of the rate of profit to decrease, caused by a changing organic composition of capital, may be overcompensated by an increasing rate of exploitation.

The Falling Rate of Profit

The rate of profit is the ratio of surplus value to total capital or $s/(c + v)$. We must remember, however, that $c + v$ signifies in this case the stock of capital and not only replacements, raw and auxiliary materials, and wages. The surplus value springs exclusively from variable capital. A higher organic composition of capital will consequently reduce the rate of profit. Since Marx believes in a law of the progressive increase in constant capital in proportion to the variable (I,682), he seems to be justified in the assumption of a gradual fall of the average rate of profit (III,248).

These assumptions, however, lead Marx into difficulty. A higher organic composition of capital would tend to reduce the rate of profit only if the rate of exploitation stays the same. An increasing rate of exploitation, however, tends to increase the rate of profit and, perhaps, to overcompensate the effect of the higher organic composition of capital.

The assumption of a constant rate of exploitation is inconsistent with other parts of Marx's system. Paul Sweezy points out that

> Marx was hardly justified, even in terms of his own theoretical system, in assuming a constant rate of surplus value simultaneously with a rising organic composition of capital. A rise in the organic composition of capital must mean an increase in labor productivity, and we have Marx's own word for it that higher productivity is in-

> variably accompanied by a higher rate of surplus value. In the general case, therefore, we ought to assume that the increasing organic composition of capital proceeds *pari passu* with a rising rate of surplus value. If both the organic composition of capital and the rate of surplus value are assumed variable, as we think they should be, then the direction in which the rate of profit will change becomes indeterminate. All we can say is that the rate of profit will fall if the percentage increase in the rate of surplus value is less than the percentage decrease in the proportion of variable to total capital.[5]

It is necessary for Marx to assume a *constant* rate of exploitation in order to maintain his theory of a "gradual fall of the average rate of profit." This necessary assumption, however, leads Marx into a fatal contradiction with the rest of his system. "For if the rate of exploitation tends to be constant, real wages tend to rise as productivity increases. Labor receives a constant proportion of an increasing total. Marx can only demonstrate a falling tendency in profits by abandoning his argument that real wages tend to be constant."[6]

Joan Robinson points out that the law of falling profits made sense in orthodox economic theory, which had no objection to the conclusion "that real wages are equated to the marginal productivity of labor" and that "the marginal productivity of labor rises as capital per man increases."[7] Marx, however, believes that real wages must remain constant (apart from minor fluctuations) because they are determined by the socially necessary labor time required for production of the means of subsistence necessary for the maintenance and reproduction of labor power. In assuming a constant rate of exploitation, however, Marx discarded one half of the theory of surplus value, viz., the part which makes the value of labor power generally equal to the minimum reproduction cost of labor power.

We shall now see how he had to discard the other half, the labor theory of value as it applies to commodities.

The Equalization of the Rate of Profit

If the rate of exploitation were the same everywhere, different fields of industry could, according to Marxian analysis, have the same rate of profit only if they had the same organic composition of capital. In practice, however, different industries have both different organic compositions of capital and, nevertheless, rates of profit which tend, in the long run, to be equal. Reality thus prevents Marx from maintaining his labor theory of value, ac-

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[5] Sweezy, *op. cit.*, p. 102.
[6] Robinson, *op. cit.*, p. 36.
[7] *Ibid.*, p. 37.

cording to which the exchange value of a commodity equals the socially necessary labor time contained in the commodity

Marx states his dilemma clearly as follows

> We have demonstrated, that different lines of industry may bave different rates of profit, corresponding to differences in the organic com position of capitals, and, within the limits indicated, also correspord ing to different times of turn over, the law (as a general teodency) that profits are proportioned as the magnitudes of the capitals, or that capitals of equal magnitude yield equal profits in equal times, applies only to capitals of the same organic cnmpositinn, with the same rate of surplus value, and the same time nf turn-over And these state ments hold good on the assumption, which has been the basis nf all our analyses so far, namely that the commodities are sold at their values On the otber baod there is no doubt that, aside from unessential, accidental, and mutually compensating distinctions, a difference in the average rate of profit nf the various lines of iodustry does not exist io reality, and could not exist without abolishiog the entire sys tem of capitalist production It would seem, then, as though the theory of value were irrecoocilahle at this point with the actual process, irreconcilable with the real phenomena of production, so that we should have to give up the attempt to uoderstaod these pheoomeoa (III,181-182)

Marx "solves" the prohlem by giving up the lahor theory of value, which was the hasis of his theory of surplus value

Competition hrings ahout an equalization of the rate of profit in the dif ferent fields of industry

> Capital withdraws from spheres with low rates of profit and invades others which yield a higher rate By means nf this incessant emigration and immigration, in one word, by its distribution among the vari- ous spheres in accord witb a rise nf the rate of profit here, and its fall there, it brings about sucb a proportion of supply to demand *that the average orofit in the varmus spheres of production becomes* the same, sn that values are cooverted into prices of production (III, 230)

To explain this cooversioo nf values into prices of production Marx uses the numerical example on page 139

We notice that Marx assumes five industries with different nrganic com positions of capital The rate nf surplns value is uniformly 100 per cent throughout the economy Thus the labor day is divided into two equal parts, e g , six bours necessary labor time and six hours surplus labor time The

surplus value is therefore always equal to the variable capital. Furthermore, since the total capital is always 100, the rate of profit is simply expressed by percentage figures equal to the surplus value. For instance, the first industry's total capital of 100 is divided between 80 *c* and 20 *v*. With a surplus value of 20, the profit is 20, or 20 per cent of the invested total capital. The "used-up" *c* refers to that portion of *c* which was used up as material and depreciation (the "wasted" part of the machinery). These figures (50, 51, etc.) are arbitrarily chosen. The value of commodities is equal to the socially necessary labor time spent in producing the commodities; i.e., $c + v + s$, where *c*, however, is only the used-up portion of constant capital ("past" labor), while *v* stands for variable capital ("present" labor) and *s*, for surplus value ("present" labor spent during the surplus labor time). For industry I, $c + v + s$ is $50 + 20 + 20$, or 90; for industry II, $51 + 30 + 30$, or 111; etc.

CAPITALS	Rate of Surplus Value: s/v	Surplus Value s	Rate of Profit: $s/(c+v)$	Used-up c	Value of Commodities: Used-up $c+v+s$	Cost Price: Used-up $c+v$
I. $80c + 20v$	100%	20	20%	50	90	70
II. $70c + 30v$	100	30	30	51	111	81
III. $60c + 40v$	100	40	40	51	131	91
IV. $85c + 15v$	100	15	15	40	70	55
V. $95c + 5v$	100	5	5	10	20	15
TOTAL $390c + 110v$		110	110%			
AVER. $78c + 22v$		22	22%			

We note that the value of commodities is not the cost price. The cost price is the value of the commodity minus the surplus value, or "used-up" $c + v$.

The situation shown in these examples leads to different rates of profit in the different industries and cannot exist in reality "without abolishing the entire system of capitalist production." Capital, therefore, begins to withdraw from the sphere with low profits (such as industries V and IV) and to enter those with high profits (such as industries III and II).

After competition has done its work,

> . . . one portion of the commodities is sold in the same proportion above in which the other is sold below their values. And it is only their sale at such prices which makes it possible that the rate of profit for all five capitals is uniformly 22%, without regard to the organic composition of these capitals. The prices which arise by drawing the average of the various rates of profit in the different spheres of production and adding this average to the cost-prices of the different spheres of production, are the *prices of production* (III,185).

The numerical example is now changed as follows

CAPITALS	Surplus Value	Value of	Cost Price of	Price of	Rate of Profit	Deviation of Price from Value
		Commodities				
I 80c + 20v	20	90	70	92	22%	+ 2
II 70c + 30v	30	111	81	103	22	− 8
III 60c + 40v	40	131	91	113	22	−18
IV 85c + 15v	15	70	55	77	22	+ 7
V 95c + 5v	5	20	15	37	22	+17

If we add the capitals used in the five industries and divide them by five, we find that on the average 78 *c* were combined with 22 *v* With a rate of surplus value of 100 per cent, the average surplus value is 22 and the average rate of profit 22 per cent

After competition has done its work, after capital has withdrawn from the industries with a lower-than average rate of profit (I, IV, V) and entered those with a higher than average rate of profit (II, III), the prices of the commodities have changed and no longer correspond to the values of the commodities The price of commodities is determined by the cost price of commodities (used-up *c* plus *v*) plus the average rate of profit For instance, in industry I the *price* of the commodity will be 70 plus 22, or 92 The *value* of the commodity, according to the labor theory of value, was 70 plus 20—or 90—and the deviation of price from value is therefore 92 minus 90—or +2

We see that the "different rates of profit are equalized by means of competition into a general rate of profit, which is the average of all these special rates of profit The profit allotted according to this average rate of profit to any capital, whatever may be its organic composition, is called the average profit That price of any commodity which is equal to its cost price plus that share of average profit on the total capital invested (not merely consumed) in its production which is allotted to it in proportion to its conditions of turn-over, is called its price of production" (III,186)

Marx has finally give up the labor theory of value Commodities do not exchange in proportion to the socially necessary labor used in their production On the contrary, their prices deviate basically and permanently from the value which corresponds to past and present labor employed in their creation Only if, per chance, an industry's organic composition of capital happens to be the average composition do price and value correspond Nevertheless, Marx upholds 'that, from the point of view of the total social capital, the value of the commodities produced by it is equal to the value of the constant capital plus the value of the variable capital plus the surplus-value" (III,196) Therefore, and since the total surplus value still determines the average rate of profit, the law of value regulates prices at least indirectly

This argument is not satisfactory. Because we are interested in *relative* prices or exchange values, we are not at all helped by the remark that in an *average* figure the deviations from the average cancel each other. Marx admits that the individual capitalist cannot see that his profit is determined by the amount of unpaid labor, because this is only accidentally true for an individual commodity (viz., if his capital happens to have the average organic composition of capital).

Even according to Marx we are only reminded in a "vague and meaningless form" of the fact that the value of the commodities is determined by the labor contained in them (III,203). But he still maintains that the law is valid, as he shows in his assumption that the labor theory of value would explain exchange values in a planned economy. "Only when production will be under the conscious and prearranged control of society, will society establish a direct relation between the quantity of social labor time employed in the production of definite articles and the quantity of the demand of society for them" (III,221).

While this cryptic passage is hard to interpret, it proves that Marx adheres to the labor theory of value in spite of the fact that it is admittedly not able to explain existing price relations in capitalism. We shall see below that it would be equally inadequate as a basis for socialist calculation and control in a planned economy.

Equalization of Profit and the Demand for Labor

We turn now to an important consequence of the competitive process which tends to equalize the rate of profit. We have seen that the rate of profit is originally high in fields of low organic composition of capital (e.g., 60 *c* and 40 *v*) and low in fields with a high organic composition of capital (e.g., 95 *c* and 5 *v*). To equalize profits, capital withdraws from fields with low profits and invades fields with high profits (III,230). Fields with high profits are those which use relatively large amounts of variable capital, i.e., industries which employ a relatively large mass of labor power. The tendency to equalize profits therefore leads to an increasing demand for labor power—a tendency which the student of Marxian economics suspected from the very beginning, as soon as he was told that only variable capital produces surplus value. Marx's argument for the contrary assumption, viz., his "law of the progressive increase in constant capital, in proportion to the variable" (I,682) rested on technological reasons and on the assumption that only labor power equipped with modern machinery could be counted as socially necessary. Competition forces the capitalist to increase more than proportionally the constant part of his total capital. This relative increase of constant capital in a given sphere of production lowers the rate of profit, in this particular sphere, below the average rate and thus calls

forth an opposite competitive change—the transfer of investment funds from industries of high organic composition of capital to those of low organic composition Thus labor, which has just been set free by the introduction of a new machine, will tend to be in greater demand than before in industries which capital newly invades in quest for higher profits

Labor power will also tend to move on its own accord The rate of exploitation tends to be the same in all industries, just as the rate of profit does This result, too, will be brought about by competitive "withdrawals" and "invasions" Marx suggests that it must be assumed "that the intensity of exploitation or the rate of surplus value, are the same" and that this presupposes "a competition among the laborers and an equilibration by means of their continual emigration from one sphere of production to another" (III,206)

We see that the law of progressive increase in constant capital has its counterpart in the law of the equalization of profit Technological progress destroys the equilibrium again and again The equality of the rate of profit is continuously disturbed But, as Heimann has shown,

> Incessantly capital is on its way to re establish equilibrium, disturbance and re-establishment face each other every moment . the dynamic law [of the industrial reserve army] throws the laborer on the street, and the static law [of profit equalization] draws him again into the labor process, the stronger the shift towards constant capital caused by progress, the stronger the instantaneous counteraction which transfers capital into the spheres with relatively much wage capital [8]

Heimann reminds us that Marx's whole theory presupposes the validity of the theory of the reserve army This theory, however, can scarcely be maintained if the very technological change which sets labor power free causes a compensating change in the organic composition of capital in favor of variable capital, i e , an increased demand for labor

[8] Eduard Heimann, *Mehrwert und Gemeinwirtschaft* (Berlin Robert Engelmann 1922), p 33

CHAPTER 13

MARXIAN ECONOMICS: CRISES, BREAKDOWN, AND SOCIALISM

Introduction

Up to now we have discussed those parts of the Marxian system which were worked out by Marx in great detail. Now we must turn to other parts which, though of crucial importance, remained in an embryonic state: the theories of commercial crises, of the breakdown of capitalism, and of socialism. Interpretation becomes here so difficult that we come upon a schism in the Marxian camp: "Orthodox" Marxists believe, as did Marx, in the eventual breakdown of capitalism as the final result of the evermore threatening return of commercial crises. The "revisionists," on the other hand, do not believe in this implicit deterioration of capitalism; they believe that socialism can be reached gradually through a process of continuous, deliberate improvements; they are not prepared to draw radically pessimistic conclusions which would condemn them to inactivity throughout the lifetime of capitalism. Socialism, for them, is not the automatic result of the final breakdown of capitalism but rather the goal of a conscious reconstruction of the social system. It can easily be seen that, with fundamentally different interests in mind, the "orthodox" and the "revisionist" Marxists came to entirely opposite explanations of the phenomena which we are now to study.

Crises

Marx never worked out a theory of business cycles, but many remarks about crises and, indeed, periodical fluctuations of the economy are scat-

tered throughout his writings They center around two distinct lines of argument Crises in capitalism are seen to result either from the tendency of the rate of profit to fall or from underconsumption caused by the antagonistic conditions of distribution

This second line of reasoning is indicated in the following passage

> The last cause of all real crises remains the poverty and restricted consumption of the masses as compared to the tendency of capitalist production to develop the productive forces in such a way, that only the absolute power of consumption of the entire society would be their limit (III,568) [1]

The connection of crises to the falling rate of profit is suggested in the statement

> The barrier of the capitalist mode of production becomes apparent in the fact that the development of the productive power of labor creates in the falling rate of profit a law which turns into an antagonism of this mode of production at a certain point and requires for its defeat periodical crises (III,303)

We shall first try to construct a cycle theory on the basis of the falling rate of profit Then we shall turn to the more powerful argument concerning general underconsumption

At first it is difficult to see why the falling rate of profit should be the cause of cyclical fluctuations If the rate of profit should really fall (in spite of an increasing rate of exploitation), this decline could at best explain a downward trend in economic activity Commercial crises must be explained differently [2] They must be related to *oscillations* of the rate of profit Marx provides us with an explanation of such oscillations in his assumption that the industrial reserve army is formed, absorbed, and re-formed periodically (I,694) and that real wages fluctuate accordingly These changes in real wages, in turn, affect the rate of profit

What causes these pulsations of the reserve army is not quite clear Marx obviously assumed, as did many cycle theorists after Marx, that the introduction of new techniques is not an even and continuous process but

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[1] Volume and page numbers in parentheses refer to Karl Marx, *Capital A Critique of Political Economy* Vol I *The Process of Capitalist Production* Vol II, *The Process of Circulation of Capital* Vol III, *The Process of Capitalist Production as a Whole* (Chicago Charles H Kerr & Company 1906 1909 1909)

[2] Marx s mechanical process of accumulation going on at an even rate—and there is nothing to show why on principle it should not—the process he describes *might* also go on at even rates, as far as its logic is concerned it is essentially prosperityless and depressionless "—Joseph A Schumpeter, *Capitalism, Socialism and Democracy* (New York Harper & Brothers, 1942), p 40

occurs intermittently. Let us, therefore, assume that a sudden increase in investment (accumulation) leads to an increased demand for labor and absorbs a part or all of the reserve army. Pressure on the labor market is reduced and real wages rise. But the increase in wages (which means a decreasing rate of exploitation) cuts into surplus value and reduces profits. With less surplus value earned, there is less surplus value to accumulate; and with falling profits, there is less inducement to invest. Thus the demand for labor decreases again.

The explanation of revival and upswing rests on the following considerations. Crisis and depression have led to the reformation of the reserve army. As the "surplus population" grows, the rate of exploitation increases. Wages fall and profits rise once again. The rise of profits is aided by the fact that the crisis has depreciated the value of existing constant capital. While the mass of constant capital has grown, its value has fallen; and the rate of profit, figured on the lower value of the constant capital, increases for those capitalists who managed to survive the storm.

This theory sounds plausible. As a matter of fact, it could be accepted even by non-Marxists. But does it explain what Marx wanted to explain, viz., that crises become increasingly worse?

If Marx were correct in his assumption of a long-run decline of the rate of profit, we could argue that business cycles, as explained above, are oscillations around a falling trend. This would, indeed, emphasize the depression phase of the cycles. But we have already seen that the rate of profit will fall only if the rate of exploitation remains the same, i.e., if real wages increase in the long run. Thus the falling rate of profit as foundation of a pessimistic cycle theory precludes the very explanation which Marx wants most to stress—that of underconsumption.

Underconsumption

Marx believes that capitalism's basic trouble is that capitalist production is limited by the consuming power of society. He says,

> The entire mass of commodities . . . must be sold. If this is not done, or only partly accomplished, or only at prices which are below the prices of production, the laborer has been none the less exploited, but his exploitation does not realize as much for the capitalist. . . . The conditions of direct exploitation and those of the realization of surplus-value are not identical. . . . The first are only limited by the productive power of society, the last by the proportional relations of the various lines of production and by the consuming power of society. This last-named power is not determined either by the absolute productive power nor by the absolute consuming power, but by the

> consuming power based on antagonistic conditions of distribution, which reduces the consumption of the great mass of the population to a variable minimum within more or less narrow limits The consuming power is furthermore restricted by the tendency to accumulate, the greed for an expansion of capital and a production of surplus value on an enlarged scale To the extent that productive power develops, it finds itself at variance with the narrow basis on which the condition of consumption rests On this self contradictory basis it is no contradiction at all that there should be an excess of capital simultaneously with an excess of population For while a combination of these two would indeed increase the mass of the produced surplus-value, it would at the same time intensify the contradiction between the conditions under which this surplus-value is produced and those under which it is realized (III,286-287)

This theory fits the Marxian system with its emphasis on exploitation When *labor is being constantly exploited* (whether it gets a subsistence wage or slightly more), when the surplus population has no income at all, when the capitalists consume only a tiny fraction of the surplus value, then it is indeed difficult to see to whom the constantly increasing output of commodities should be sold

But was Marx really entitled to draw these pessimistic conclusions, even within the logic of his own system? For an answer to this question (which is important because the breakdown of capitalism depends on it), we have to consider the following points

(1) Was Marx justified in using the underconsumption theory in spite of his own criticism of the "naive" underconsumptionists? Marx calls it a tautology to say "that crises are caused by the scarcity of solvent consumers, or of paying consumption," (II,475), and he continues,

> But it one were to attempt to clothe this tautology with a semblance of a profounder justification by saying that the working class receive too small a portion of their own product, and the evil would be remedied by giving them a larger share of it, or raising their wages, we should reply that crises are precisely always preceded by a period in which wages rise generally and the working class actually get a larger share of the annual product intended for consumption (II,476)

Marx wanted to make it clear that the difficulties could not be overcome, as some underconsumptionists argued, by simply raising wages We meet here with the problem which is so persistently found in all wage discussions that wages are the main source of demand, but that they are, at the same time, a cost factor Marx was, of course, interested in barring this simple

remedy for capitalism's death struggle. But he was right in rejecting wage increases as a simple recipe.

(2) Marx's underconsumption theory conflicts, as we saw, with his theory of the falling rate of profit. The rate of profit will fall only when, with the relatively faster growth of c in relation to v, the rate of exploitation stays the same. Then real wages will rise with an increase in productivity and capitalists will have a market for their products to realize their surplus value.

(3) Independently of the theory of the falling rate of profit we must reject Marx's argument that labor cannot get more than the means of subsistence. We remember that this theory rests on the presence of the reserve army and on the pressure it exerts on the labor market. But it is circular reasoning to make the reserve army (the result of crisis and depression) the foundation of the theory of surplus value, which explains the antagonistic conditions of distribution and, through underconsumption, crisis and depression.

(4) If we follow the interpretation of orthodox Marxists, like Rosa Luxemburg, we are given such an extremely pessimistic estimate of consuming power that it is, indeed, difficult to see how capitalism could possibly have developed "the colossal productive forces" which Marx admired. If only v and a tiny portion of s are consumed, how can the accumulation of more and more s (under conditions of constantly increasing exploitation) proceed without running from the outset into "realization" trouble? Why was capitalism, under such conditions, not stillborn from the very beginning?

(5) Paul Sweezy answers this apparent paradox (that capitalism expanded prodigiously in spite of the fact that it tends always toward stagnation) by drawing our attention to certain "counteracting forces" to underconsumption. They are (1) new industries, (2) faulty investments, (3) population growth, (4) unproductive consumption, and (5) state expenditures.[3]

Sweezy points out that "during the formative period of a new industry there is no clearly defined relation between additions to means of production and additions to the output of finished products."[4] From this he concludes that the process of industrialization counteracts the tendency toward underconsumption, as during the eighteenth and nineteenth centuries.

Sweezy seems to visualize capitalist development as a kind of roller coaster: the expansion process of the industrial revolution first lifts the economy to great heights from which it will then coast down with exciting bumps until the end is reached. That industrial expansion over a century and a half should be possible before capitalists notice that the antagonistic

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[3] Paul Sweezy, *The Theory of Capitalist Development* (New York: Oxford University Press, 1942), pp. 217-218. Copyright 1942 by Oxford University Press.
[4] *Ibid.*, p. 218.

conditions of production do not permit them to sell their products is hard to believe Only if the increased output can be sold at reduced prices, thus increasing real wages, can the process of industrialization grow beyond the very first beginning

Faulty investments absorb accumulation without adding to the output of consumers' goods but are hardly of sufficient quantitative importance to explain why underconsumption did not stop capitalist growth a long time ago

Population growth, according to Sweezy, permits a rapid growth of variable capital 'without any upward pressure on the wage level and hence without an adverse effect on the rate of profit' [5] But Sweezy forgets to mention that this rapid growth of the labor force takes place within the existing antagonistic conditions of income distribution and thus cannot help to solve the problem of underconsumption

The reader may have noticed that the arguments concerning new industries and population growth are Marxian adaptations of the stagnation theories of the nineteen thirties

Sweezy's last two points, viz, unproductive consumption and government expenditures, are known to us as devices by which we may try to maintain a sufficient amount of aggregate expenditure But orthodox Marxists must beware of this argument Sweezy himself asks,

> If the drift to economic stagnation can be successfully countered, then why must we assume that unemployment, insecurity, sharper class and international conflicts are in prospect for capitalism? Why not, on the contrary, a "managed' capitalist society, maintaining economic prosperity through government action and perhaps even gradually evolving into a full fledged socialist order?[6]

(6) Still another difficulty arises in connection with the theory that capitalists cannot realize surplus value Even if we should accept this underconsumption theory, it does not provide us with a theory of *cyclical fluctuations* Sweezy's counteracting forces could perhaps be used to show why the downward trend can be interrupted But we have seen that Sweezy's argument does not fit the logic of Marx's system And the falling rate of profit argument, enriched by reference to the formation, absorption, and reformation of the reserve army, cannot help us either If we have settled on underconsumption as the main argument, we are exposed to the same criticism which Marx used against the 'naive" underconsumptionists, i e, why should the main trouble be found in underconsumption if wages rise during prosperity? It is true that wages have to be viewed not only from the demand but also from the cost side But if insufficient demand is the

[5] *Ibid* p 222
[6] *Ibid* p 236.

main cause of the trouble, it does seem strange that the economy should suffer most when, for once, demand has grown.

Breakdown and Imperialism

In Chapter 8 we saw how modern non-Marxian theory can explain economic fluctuations, and in Chapter 9, how monetary and fiscal policies can be employed to maintain a reasonably high employment level. Decisive is the fact that we *can* deal successfully with recession and depression *within the framework of capitalism.*

This optimistic conclusion discredits modern cycle theory in the eyes of orthodox Marxists. As Sweezy puts it,

> If crises are really caused by nothing more intractable than disproportionalities in the productive process, then the existing social order seems to be secure enough. . . . Not only need there be no collapse of capitalism, but much can be done even under capitalism to iron out the disproportionalities which are the cause of much needless suffering.[7]

We know what Marx wanted to prove. We remember that he wanted to show how existing property relations turn from forms of development of the forces of production into their fetters, so that eventually social revolution will come by necessity. But while Marx's aim was unmistakable, his economic theories did not support his pessimistic preconceptions. Obviously, Marx found it impossible to gather together the different strands of his economic theory into a unified breakdown theory. If all his arguments had clearly pointed to this coveted result, he certainly would not have hesitated to formulate this climactic conclusion. But we have seen that Marx's arguments are highly contradictory, even when taken on Marx's own terms, i.e., even when we leave out those criticisms which invalidate the theory of surplus value from the start. Here the door stood wide open for those who did not want to follow Marx's pessimistic philosophy. A conflict among Marx's disciples was unavoidable.

The orthodox Marxists were right in their interpretation of Marx's philosophy. Marx was convinced that the capitalist relations of production will turn into fetters of production, that the proletariat will eventually overturn the existing relations of production, and that this change will be brought about in a final crisis, the last and worst in a series of crises which had become increasingly threatening. The way to socialism is inexorable and dismal.

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[7] *Ibid.*, pp. 160-161.

> The modern laborer instead of rising with the progress of industry, sinks deeper and deeper below the conditions of existence of his own class He becomes a pauper, and pauperism develops more rapidly than population and wealth And here it becomes evident that the bourgeoisie is unfit any longer to be the ruling class in society, and to impose its conditions of existence upon society as an overriding law [8]

If this interpretation of capitalist development is accepted, it is impossible and therefore unwise to try to improve the conditions of the masses under capitalism It is impossible, at least in the long run, because higher real wages lead only to depression, it is unwise because it is a wasted effort to try to improve a system which is entirely beyond repair That workers form increasingly powerful unions is important in view of the final struggle which is shaping up between bourgeoisie and proletariat Material improvements for the working class, however, can be reached only for short periods The real fruit of the workers' battle "lies not in the immediate result but in the ever-expanding union of workers " [9]

But in trying to support Marxian philosophy with Marxian economics, the orthodox school was bound to run into difficulties How was it possible for capitalism to maintain itself as long and as well as it did, in spite of all the dire predictions?

The main answer to this question was the theory of imperialism

If capitalism suffers from underconsumption, if surplus value cannot be realized capitalism can maintain itself only by sales outside the capitalist system "Outside" refers to other countries, but it may also mean segments of the same country which are not yet part of the capitalist process

The *Communist Manifesto* makes an implicit reference to imperialism when, in answering the question, "How does the bourgeoisie get over these crises?" it points to "the quest of new markets" and "the more thorough exploitation of old ones " [10]

Marx did not follow up this idea To simplify his analysis, his model considered the whole commercial world one nation under the assumption that capitalist production would be characteristic for the whole world (I, Chap 22) He expressly stated [illegible] n[illegible] [illegible]ional trade would only confuse the issue wi[illegible] a new [illegible] to the

rest of the noncapitalist world would, after all, soon be absorbed; and in the process more and more countries would become, via industrialization, subjects rather than objects of imperialism.

Most consistent and therefore most vulnerable was Rosa Luxemburg's theory of imperialism.[11] Because it is impossible to dispose of the total social output within the capitalist system, she observes, surplus value can be realized only through sales to noncapitalist consumers. Unfortunately, Rosa Luxemburg was not able to tell us how the noncapitalist consumer is able to buy the products which he imports from capitalist countries. The correct answer is simple enough. He can buy only if he is able to sell, i.e., export. Thus in the capitalist country foreign products take the place of home-produced commodities, but the total mass of value which has to be sold remains the same. As a matter of fact, since the profits of trade with the underdeveloped areas will be particularly great, the realization is made even more difficult.[12] It is obvious that international lending would not solve this problem in the long run.

Rosa Luxemburg's theory was not well received by her fellow Marxists. That the revisionists had no use for it is easily understood; those who did not believe in underconsumption as the basic difficulty of capitalism had no reason to subscribe to this weak subterfuge. More interesting is the fact that Luxemburg's theory of imperialism did not find favor with "orthodox" authors. N. I. Bucharin made the reason for this negative attitude quite clear. "If the theory of Rosa Luxemburg were even approximately correct, then truly the cause of revolution would be in a bad way since with the existence of such a huge reservoir of 'third persons,' as it de facto exists, we could not speak of a breakdown in a practical sense." [13] We see that it was not only the revisionists who were disinclined to wait for the eventual downfall of capitalism. Orthodox Marxists, too, favored an interpretation of the breakdown which did not bind their hands for too long.[14]

Revisionism

The pessimistic orthodox viewpoint was unacceptable to Marxists who wanted to achieve immediate economic improvement and who found

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[11] Rosa Luxemburg, *Die Akkumulation des Kapitals. Ein Beitrag zur ökonomischen Erklärung des Imperialismus* (Berlin: Vereinigung Internationaler Verlagsanstalten, 1922).

[12] See Werner Alexander, *Kampf um Marx* (Potsdam: Alfred Protte Verlag, 1932), p. 128.

[13] N. I. Bucharin, *Der Imperialismus und die Akkumulation des Kapitals* (Wien-Berlin: Verlag für Literatur und Politik, 1926), p. 117. "Third persons" are those who do not belong either to the bourgeoisie or to the proletariat, they are outside the capitalist system, whether at home or abroad.

[14] We will not discuss in this context Lenin's theory of imperialism, since it is not directly connected with Marx's underconsumption theory. Cf. V. I. Lenin, *Imperialism* (New York: International Publishers Company, Inc., 1933), p. 81.

Marx's breakdown theory unconvincing, both on theoretical grounds and also in light of the undeniable, steady, long run improvement in the standard of living of the working classes during the second half of the nineteenth century

The revisionists did not want to deny the existence of exploitation or the desirability of socialism, but they arrived at totally different conclusions concerning the approach to socialism Characteristic is the following statement taken from the *Economic Democracy Program* of the German socialist labor unions in 1928

> The aim of socialism remained unchanged in the modern labor movement, but the ideas about the way that leads to this aim have undergone a change with the growth of the movement and the change of capitalism What once appeared a distant dream has become for the present day a visible process of development, a practical task of realization, divided into a large number of single tasks [15]

It is doubtful whether the term "revisionism" is really appropriate Revision means an altered interpretation But the term can hardly be used any longer when nothing of the original doctrine is left This is true not only for the quoted document but even for the originator of the revisionist movement, Eduard Bernstein, whose real aim, according to Sweezy, "was to eradicate Marxism, root and branch, from the socialist movement," though he may not have been fully conscious of it [16]

Thus we see that both the revisionist and the orthodox Marxists were quite willing to disregard Marx where his theory of capitalist development did not suit their impatience to get down to business the business of gradual evolution through gradual improvements, or the business of establishing socialism by revolution before the breakdown has occurred—even in only one country, if need be, and that, the least developed of all, Russia

Socialism and Communism

Marx says very little about the future economic system, and what be says is vague The future economy will be a planned economy "The point of bourgeois society consists precisely in this, that *a priori* there is no conscious social regulation of production " [17]

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[15] *Wirtschaftsdemokratie* (Berlin Verlagsgesellschaft des Allgemeinen Deutschen Gewerkschaftsbundes 1928) p 10

[16] Sweezy, *op cit* p 193

[17] *Letters to Kugelmann* (New York International Publishers 1934), p 74 A collection of the few references in Marx s writings to the problem of economic calculation in socialism can be found in K Tisch *Wirtschaftsrechnung und Verteilung im zentralistisch organisierten sozialistischen Gemeinwesen* (Wuppertal Elberfeld 1932),

But how will the plan operate? Which problems are to be solved and which solution is proposed?

In an interesting passage on Robinson Crusoe (I,88), Marx points out that necessity itself compels Robinson "to apportion his time accurately between his different kinds of work." Like a trueborn Briton he keeps a set of books in which he keeps account of the labor time that definite quantities of different objects have cost him. Marx continues to show how "all the characteristics of Robinson's labor" are repeated in a community of free individuals "carrying on their work with the means of production in common." One portion of the social product serves as fresh means of production and remains social. Another portion is consumed by the members as a means of subsistence. Marx assumes ("but merely for the sake of a parallel with the production of commodities")

> . . . that the share of each producer in the means of subsistence is determined by his labor-time. Labor-time would, in that case, play a double part. Its apportionment in accordance with a definite social plan maintains the proper proportion between the different kinds of work to be done and the various wants of the community. On the other hand, it also serves as a measure of the proportion of common labor borne by each individual and of his share in the part of the total product destined for individual consumption (I, 90-91).

Marx emphasizes the fact

> . . . that this necessity of distributing social labor in definite proportions cannot be done away with by the *particular form* of social production, but can only change the *form it assumes*. No natural laws can be done away with. What can change, in changing historical circumstances, is the *form* in which these laws operate.[18]

Marx expresses similar ideas in Volumes II and III of *Capital*, where he points out that bookkeeping is more necessary in cooperative (perhaps he should have said collectivist) than in capitalist production (II,153). Value in terms of labor time will be the governing principle, and bookkeeping in units of labor time will establish a direct relation between the quantity of social labor time employed and the demand of society for commodities (III,221).

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pp. 110-115; Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism* (Minneapolis: University of Minnesota Press, 1938), Appendix; M. M. Bober, "Marx and Economic Calculation," *American Economic Review*, XXXVI (June, 1946), 344-357.

[18] *The Correspondence of Marx and Engels* (New York: International Publishers, 1934), p. 246. Oskar Lange says of this passage that it disproves "the generally accepted view that Marx regarded *all* economic laws as being of a historico-relative character."—Lange and Taylor, *op. cit.*, p. 132.

That Marx returns here to the labor theory of value (in contradistinction to the concept 'price of production") might seem to rescue the labor theory of value and to prove the superiority of the collectivist economy In reality these passages prove only that Marx did not see the main problem facing the socialist economy The socialist economy not only has to allocate labor to its proper uses but also has to determine the most economical use of *all* the scarce factors of production—natural resources and capital goods as well as human labor This problem will be discussed at length in the following chapters

Marx distinguishes two stages in the development of the future society Between the capitalist and the communist society lies the period of revolutionary *transformation* of one *into* the other This *period*, sometimes referred to as socialism, corresponds to a period of political transition in which the state can be nothing but an instrument of the revolutionary dictatorship of the proletariat Socialism, in contradistinction to communism, is characterized by the fact that the laborer is still rewarded in proportion to his contribution He is no longer exploited but instead receives an income in proportion to labor rendered And since different laborers contribute different quantities of socially necessary labor, incomes will differ Then Marx continues,

> In a higher phase of communist society, after the tyrannical subordination of individuals in the division of labor and thereby also the distinction between manual and intellectual work, have disappeared, after the productive forces have also increased and all the *springs of social wealth* are *flowing* more *freely*, along with the all-round development of the individual, then and then only can the narrow bourgeois horizon of rights be left far behind and society will inscribe on its banner "From each according to his capacity, to each according to his need "[19]

Marx has a rather fantastic idea of the degree of productivity which can be achieved once the antagonistic conditions of distributon are finally abolished Not only will it no longer be necessary to limit consumption, it will presumably no longer be necessary to allocate labor, since we can discontinue the practice of increasing productivity through division of labor Now the time has come when the individual will hunt in the morning, fish in the afternoon, rear cattle in the evening and criticize after dinner, without specializing in any one of these occupations [20]

M M Bober correctly remarks that the contradictions *in these* statements need no elaboration

[19] Karl Marx *Critique of the Gotha Program* (London Martin Lawrence, 1933), p 31 quoted in the slightly revised translation of [illegible] Bober, *loc* [illegible] 352 353
[20] Marx Engels *Die Deutsche Ideologie* (Ber[illegible] kritis[illegible] 1927 1932), Part I, Vol 5, p 22 Quoted in [illegible] 351

> The loss of the advantages of the division of labor; the expenditure of resources to train each individual in several trades; the huge amount of bookkeeping required for the functioning of such a scheme; and the incompatibility of the one criterion, production and utility, with the other criterion, the development of the physical and intellectual capacities of the worker—these are some of the considerations that come to mind. The fact that Marx is unimpressed by such considerations argues that labor-value is not what he has in mind as the guide to the productive organization under communism.[21]

Thus we lose sight of Marx's earlier concession that, in any social system, labor would have to be distributed in definite proportions. It seems that this statement actually referred only to the socialist interval between capitalism and communism. As far as communism is concerned, Marx seems to assume a degree of productivity which would eliminate altogether the necessity of economizing. This "solution" of the economic problems of communism, however, is purely utopian.

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[21] Bober, *loc. cit.*, p. 352.

PART FOUR

THE ECONOMIC THEORY OF LIBERAL SOCIALISM

CHAPTER 14

THE SOCIALIST ECONOMY AND ITS PROBLEMS

An "Underdeveloped" Theory

With the growing importance of socialism as a political power we should expect to find a substantial body of doctrines referring to the economics of socialism. If we want to build a house, we need a blueprint; if a new social order is to be constructed, we should expect to find the proponents of the new system busy drawing up various detailed outlines of the advocated order. Criticism of capitalism is not sufficient for this purpose. To our surprise, however, we find the economic theory of socialism in a very rudimentary state of development. The considerations listed below may help to explain this strange situation.

(1) We have already seen that Karl Marx is largely to blame. Economic Marxism is a critique of capitalism which has practically nothing to say about the structure and the working principles of the collectivist economy. Marx's severe criticism of the capitalist system, furthermore, made it impossible for an orthodox Marxist to base his blueprint of socialism on principles similar to the pricing process of capitalism; on the contrary, market prices had to be abolished to make room for application of the labor theory of value.

(2) "Bourgeois" economists, too, were to blame for the neglect of the important problem of how a socialist economy could function. The classical economists assumed that the institutional setup of capitalism, i.e., private property in the means of production, was the only logical and possible framework for their studies.

(3) A few relatively modern writers tried to "transcend" the institutions of capitalism and to prove the general applicability of the principles of the market economy. Although this attitude promoted to some extent

the theory of economic socialism, it proved detrimental to that theory's further development when it tended to overlook essential practical problems which had to be solved A case in point is Cassel's theory, which has been discussed in the Appendix to Chapter 3 (pp 320 328) Even more extreme is F H Knight, who holds that the economic theorist has little or nothing to say about socialism because the bare fact of substituting a collectivist for a competitive individualist form of organization "does not logically or necessarily imply any particular change whatever, in the empirical course of social economic life "[1] Considering that such a change concerns the abolition of private property in the material means of production, this is an extreme statement, whose weakness will be revealed by the discussions in the following chapters

(4) F A Hayek has pointed out that the very fact that, in capitalism, most social-economic problems are solved without conscious decision by anybody "has the effect that most people are not conscious of their existence "[2] We are often willing to criticize capitalism and eager to change or abolish some of its features, but at the same time we take more or less for granted that the regulating forces of the market economy would go on working in spite of these changes To assume that we can change the institutions of a given social order at will and still retain all the features which we do not expressly want to change is quite wrong and dangerous The institutions and working principles of an economic system are so closely interrelated, that one change may necessitate other changes which we did not bargain for

(5) If classical economics often neglected the particular institutional characteristics of an economic system, the opposite attitude, viz. exaggerated emphasis on historical and institutional data, was not very helpful either for the development of the economic theory of socialism The historical and institutional schools of economics often did nothing but record and describe institutional changes, sometimes even denying the existence of any economic laws[3] With this attitude one could not come to useful conclusions concerning a collectivist economy of the future

Thus we see that several schools contributed to the strange result that no blueprints for a socialist economy developed before World War I[4]

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[1] Frank H. Knight, "The Place of Marginal Economics in a Collectivist System," *American Economic Review*, XXVI (March, 1936), 255 266

[2] *Collectivist Economic Planning* Critical Studies on the Possibilities of Socialism, by N G Pierson, Ludwig von Mises Georg Halm, and Enrico Barone ed with an Introduction and a Concluding Essay by F A Hayek (London George Routledge & Sons Ltd , and Kegan, Paul, Trench, Trubner & Co., Ltd., 1935), p 7

[3] See Hayek, *loc cit*, p 10

[4] Some work had been done earlier See for example, the papers by N G Pierson (1902) and Enrico Barone (1908) which are included in *Collectivist Economic Planning*

Russia and Germany

After World War I the economics of socialism could no longer be treated as a problem of the distant future. Socialist and communist parties came to power, and socialist ideas were put to the test. This development was particularly true for Russia and Germany. In both countries it could now be seen that the parties of the left were ill-prepared for the difficult task which they promised to undertake. In Russia the new economic system went through chaotic, dangerous, and painful years of experimentation before the central plan began to emerge. Some of the transition difficulties were, of course, independent of the new social experiment. But we have Lenin's own word for it that most of the chaos then existing in Russia was due to the fact that the Bolshevists had been utterly unprepared for the gigantic task they undertook. Experience has convinced us, Lenin wrote, "that it is impossible to reach even the lowest stage of communism, without having passed through a period of socialist accounting and control." [5]

In Germany the revisionist Marxists came to power. Without a theory of the socialist economy, they had no program of action in the economic field. Finally, after ten years of silence, the socialist labor unions published a program of *Economic Democracy*,[6] in which they enumerated carefully and rather pedantically whatever they considered progress in the direction of socialism: autonomous boards, government-owned enterprise, cartels (!), social insurance, labor legislation, consumers' cooperatives, labor unions, etc. The nationalization of large-scale industry was envisaged under the influence of wartime experiences. No radical changes were desired; the capitalist system was to be altered only gradually. The novel idea that representatives of labor should participate in the management of industry, and not only in the handling of labor relations, did not prove very fruitful, since management of industry does not lend itself to decisions slowly arrived at by a body whose members often represent opposing interests.

No change occurred in the economic structure of Germany which would deserve the name socialism. The German economy remained a capitalist economy—a situation repeated in England after World War II.

Today we find centrally planned industrial economies only in countries under communist dictatorship. No centrally planned liberal socialist economy exists on this side of the iron curtain, and no developed industrial economy outside the communist bloc conforms to the definitions of socialism which we find in socialist literature. The economies of the democratic

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[5] Quoted in Friedrich Pollock, *Die planwirtschaftlichen Versuche in der Sowjetunion 1917-1927* (Leipzig: Verlag C. L. Hirschfeld, 1929), pp. 101-102.

[6] *Wirtschaftsdemokratie, Ihr Wesen, Weg und Ziel,* herausgegeben im Auftrage des Allgemeinen Deutschen Gewerkschaftsbundes von Fritz Naphtali (Berlin: 1928).

countries are market economies in which the ownership of the material means of production is still predominantly in private hands But since some government administrations *aim* at socialism, at least through a gradual evolution of capitalism, we do find economies of a somewhat hybrid character These we shall have to discuss later on

Rather than begin with a study of existing "mixed" economies we shall study a *blueprint* of liberal socialism which has been frequently used in recent discussions With the theoretical knowledge so gained it will be easier to understand the problems of the hybrid or mixed systems We need strong theoretical guidance if, for example, we want to understand the problems of countries which grope for new solutions in their search for quick economic development The difficulties faced by these countries show how important it is that more work be done in this rather neglected field—the economic theory of socialism

Mises' Attack

Just after World War I, when socialist parties had a chance to prove, if they could the superiority of socialism as an economic system, Ludwig von Mises tried to show that any attempt to create a functioning, rational, productive socialist economy was doomed to failure [7]

Mises assumes that in a socialist economy production goods are exclusively communal and therefore *res extra commercium* Because production goods are publicly owned they will never become objects of exchange, and it will be impossible to determine their monetary value Calculation of costs in terms of money will thus be impractical, and without cost calculation there can be no real economy Without a compass, the socialist order will flounder in the ocean of countless possible or conceivable economic combinations of its productive resources

The importance of Mises' argument was acknowledged on the socialist side Oskar Lange begins his *Economic Theory of Socialism* with the remark that socialists "have certainly good reason to be grateful to Professor Mises for it was his powerful challenge that forced the socialists to recognize the importance of an adequate system of economic accounting to guide the allocation of resources in a socialist economy" Facetiously, he goes on to say that 'both as an expression for the great service rendered by him and as a memento of the prime importance of sound economic accounting, a statue of Professor Mises ought to occupy an honorable place in the great hall of the Ministry of Socialization or of the Central Planning Board of the socialist state " [8]

[7] Ludwig von Mises Economic Calculation in the Socialist Commonwealth, in *Collectivist Economic Planning* pp 87 130

[8] Oskar Lange and Fred M Taylor, *On the Economic Theory of Socialism* (Min-

Since the theory of economic calculation in socialism started, in the main,[9] with this attack by Mises, we must note the assumptions and implications of Mises' criticism.

(1) Mises' basic assumptions are rather extreme. He discusses an authoritarian, centrally planned economy rather than a liberal socialist economy with free choice of consumption and occupation.

(2) He insists that the planned economy needs consistent cost calculation, which, he says, is only feasible when it is based on an all-inclusive pricing process. The government must act economically and must know what to produce, how much, and by which methods; i.e., it must be able to allocate the factors of production rationally. The means of production are not less scarce than before, simply because they are now owned by the government.

(3) Economic calculation does not rest on labor costs alone. Investment funds and natural resources are in need of the same careful and consistent allocation as are the different kinds of labor.

(4) This calculation and allocation cannot take place *in natura;* cost accounting in physical terms is impossible. There must be exchange values in monetary units, i.e., prices, for consumers' goods, intermediate goods, and the services of the factors of production.

(5) Private ownership of the material means of production is absolutely necessary. Only on the basis of private property is it possible to establish real exchange relations, the precondition for the formation of market prices. "When the 'coal syndicate' provides the 'iron syndicate' with coal, no price can be formed, except when both syndicates are the owners of the means of production employed in their business."[10] In other words, the pricing process has to rest on real markets where private firms buy and sell competitively and are motivated by profit expectations.

The Socialist Answer

Mises' challenge was accepted by some socialist economists, but in ways which emphasized the fundamental difference that exists between the economics of liberal and of authoritarian socialism.

Liberal socialist writers assume (in contradistinction to Mises' premises)

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neapolis: University of Minnesota Press, 1938), pp. 57-58. Copyright 1938 by the University of Minnesota.

The Marxist, Otto Leichter, wrote in 1923: "To Max Weber and Ludwig Mises belongs the merit of having so energetically drawn the attention of socialists to this question. However little it was the intention of Mises to contribute by his criticism to the postive development of socialist theory and praxis, yet honor must be given where honor is due." Quoted in T. J. B. Hoff, *Economic Calculation in the Socialist Society* (London: William Hodge and Company Limited, 1949), p. 3.

[9] But see footnote 4 on p. 160.

[10] Mises, *loc. cit.*, p. 112.

socialism, between liberal capitalism and authoritarian capitalism, and between authoritarian capitalism and authoritarian socialism.

(1) COLLECTIVISM. The collectivist economy is characterized by the conscious setting of aims for the economy as a whole and implies an authority which sees to it that these aims are reached. We may call "collectivist" all programs, institutions, and measures which consciously regulate, control, or plan the economy so that predetermined results are achieved. These regulations, controls, or plans may concern total aggregate demand, full employment of the factors of production, satisfaction of communal demand, allocation of factors of production, distribution of the national income, the amount of capital accumulation, economic development, the building-up of a war machine, etc.

Collectivism is therefore clearly distinguished from the private enterprise sector of the capitalist economy, which rests on independent actions of individual economies and where production and distribution are the automatic result of market forces. Collectivism, however, is not clearly distinguished from capitalism as a whole. Collectivism and capitalism overlap in the following cases:

(a) The capitalist economy has a public sector to satisfy collective wants. This sector corresponds to our definition of collectivism: aims are consciously set and achieved; the automatic forces of the market are either not at play or they have no commanding influence on our decisions. No sharp line can be drawn between economic systems according to the size of the public sector. We cannot say that capitalism ends and socialism begins when more than, say, 50 per cent of a country's resources are used to satisfy collective wants.

(b) The government can attempt to plan total aggregate spending to maintain a high level of employment and to keep in check both inflation and deflation. More recently this type of collectivism (which is as old as monetary policy) has grown greatly in importance. Monetary and fiscal controls have become liberal capitalism's main answer to liberal socialism's more far-reaching requests.

(c) Wartime experiences show that the private enterprise economy can be subjected to a degree of centralized control which establishes a planned economy in all but name and achieves productive results of an essentially collectivist character regarding both aims and methods.

A term like "collectivism" can become dangerous when slovenly used. Many social systems can rightly be called collectivistic and yet not have more in common than, say, public ownership of the material means of production or a central plan. In all other respects they may be as different as liberal socialism is from communism or fascism. Suppose that an author uses the term "collectivism" alternately for both socialism and fascism in

free choice of occupation and coosumers sovereignty This permits exist eoce of real markets for labor and for consumers' goods io the liberal socialist economy But substitutes must be found for the market prices which cease to exist when the government becomes the owner of the material means of production (eapital and land) Some liberal socialists suggest that prices chosen by the government can be substituted for market prices and that economic calculation and the allocation of resources can therefore be based on a complete set of cost and price data

Followers of Mises have admitted that in this or in some other ways a *theoretical* solution of the allocation problem in socialism could be found Indeed the whole discussion might end here with the victory of liberal socialism over Mises dire predictions were it not for the fact that the *theoretical* or *abstract* solutions seem as yet unable to produce convincing *practical* results—as will be shown below

Authoritariao socialists unlike liberal socialists do not believe in the sanctity of consumers sovereignty On the contrary they believe consumers sovereignty to be impossible if socialism is to mean a centrally planned economy Much can be said for this viewpoint since it is indeed difficult to see how a central plan and much personal freedom cao be successfully combined To some extent the authoritarian socialists support therefore the charge that a l beral socialist solution is not practical

We shall first indicate the problems faced by socialism in the allocation of the factors of production (economic accounting) and then discuss the proposed liberal and authoritarian solutions The discussion of the authoritarian solution can to some extent be illustrated by examples taken from Soviet Russian experiences (see Chapter 19) For the liberal socialist solution a verification by experiment is not yet possible because a liberal socialist system does not exist As a matter of fact we shall see that the welfare states which perhaps come nearest to the liberal socialist philosophy do not show a full understanding of the problems of consistent allocation (see Chapter 21) No close relation exists between liberal socialist theorizing and the practice of welfare economics

Definitions

To prepare for our discussioo of liberal and authoritarian socialism we must try to d sentangle a somewhat confused terminology That we meet with difficulties here is eas ly understood It is impossible to separate social economic systems cleanly to find the exact notch where the knife should slice down This statement applies not only to the distinction between the main types of socialism (and the possible gradations within these main types), but equally to the distinctioo between liberal capitalism and liberal

socialism, between liberal capitalism and authoritarian capitalism, and between authoritarian capitalism and authoritarian socialism.

(1) COLLECTIVISM. The collectivist economy is characterized by the conscious setting of aims for the economy as a whole and implies an authority which sees to it that these aims are reached. We may call "collectivist" all programs, institutions, and measures which consciously regulate, control, or plan the economy so that predetermined results are achieved. These regulations, controls, or plans may concern total aggregate demand, full employment of the factors of production, satisfaction of communal demand, allocation of factors of production, distribution of the national income, the amount of capital accumulation, economic development, the building-up of a war machine, etc.

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(b) The government can attempt to plan total aggregate spending to maintain a high level of employment and to keep in check both inflation and deflation. More recently this type of collectivism (which is as old as monetary policy) has grown greatly in importance. Monetary and fiscal controls have become liberal capitalism's main answer to liberal socialism's more far-reaching requests.

(c) Wartime experiences show that the private enterprise economy can be subjected to a degree of centralized control which establishes a planned economy in all but name and achieves productive results of an essentially collectivist character regarding both aims and methods.

A term like "collectivism" can become dangerous when slovenly used. Many social systems can rightly be called collectivistic and yet not have more in common than, say, public ownership of the material means of production or a central plan. In all other respects they may be as different as liberal socialism is from communism or fascism. Suppose that an author uses the term "collectivism" alternately for both socialism and fascism in

order to prove that all the shortcomings of one are equally the shortcomings of the other The terms serves here as a kind of terminological turn table which is used unjustly to shift the argument from one system to the other, and an unaware reader may soon come to believe that, for instance, liberal socialism is exposed to all the vices of fascism

(2) AUTHORITARIAN CAPITALISM (FASCISM) Many far reaching controls are temporarily applied and accepted in democratic capitalism during total war If such controls are made permanent for the achievement of collective peacetime purposes, we establish an authoritarian capitalist system Fascism is in appearance capitalist because it super ficially maintains private property in the means of production has essen tially the same income distribution as the private enterprise system, and maintains, on paper, the same economic freedoms to consume and to work, together with private initiative and competition Nevertheless, fascism im plies a totalitarian collectivist plan because social aims are consciously set by the leader and because these ends, in case of conflict, always take preced ence over the private ends of individuals ('Gemeinwohl geht vor Eigen wohl') To achieve the ambitious aims of the dictator necessitates establishment of a system of controls which in scope and degree of integration amounts to a central plan

(3) CENTRAL PLANNING This term, too, has to be used with care In a discussion of socialist systems we are concerned with *central* planning The individual economy in a private enterprise system, when acting rationally, also plans It employs systematic thinking, it allocates its resources with a given end in mind, and it wants to achieve this end with the least expenditure of scarce resources But this is not central planning Central planning concerns the economy as a whole In this sense all collec tivist economies (or at least all collectivist sectors of social economies) are centrally planned This implies an authority which knows what goals have to be reached and what resources are available for this purpose •

H D Dickinson adopts the following definition of planning "Economic planning is the making of major economic decisions—what and how much is to be produced how, when and where it is to be produced, and to whom it is to be allocated—by the conscious decision of a determinate authority, on the basis of a comprehensive survey of the economic system as a whole " [11] This definition does not state by what method allocation of the factors of production is to be accomplished or how much room will be given to managerial decentralization Later on, Dickinson suggests that 'we may apply the term planning to schemes of economic control that deal with the broad outline of economic activity, without regulating details, provided

[11] H D Dickinson *Economics of Socialism* (London Oxford University Press 1939), p 14

that, so far as they go, they treat the economic system as a who[illegible] an example of this type of planning Dickinson mentions "schem[illegible] liberate control of the price level."

Following Dickinson, we must come to the conclusion that the [illegible] economy and the collectivist economy are identical and that the many facets of collectivism are mirrored in the kaleidoscopic character of the term planning. It would perhaps be wise, however, to reserve the term "central planning" for Dickinson's first definition and to refer to those broad policies of a monetary and fiscal character merely as indirect controls.

Where the material means of production are owned and operated by the government, it seems obvious that they should be allocated in a definite, predetermined way. No doubt, most socialists think of socialism as such a centrally planned economy. Yet, if we stress the centralist character of the plan, we are in danger of ignoring the crucial difference between liberal and authoritarian socialism.

There is, indeed, a tendency among socialist writers to soft-pedal the difference between the two systems. The authoritarian socialist sometimes wishes to create the impression that the central plan could be combined with a great deal of freedom for the consumers, the workers, and the managers on the spot. Liberal socialists, on the other hand, while emphasizing freedom, nevertheless want to create the feeling that their economy would enjoy all the advantages of central planning.

We shall have to study this difficult problem of freedom under central planning. Both liberal and authoritarian socialists profess that freedom and planning can be combined; but they differ substantially in emphasis. The central planner often shows little concern for individual liberties; and for the liberal socialist the central plan is often a *deus ex machina,* used when the liberal socialist blueprint threatens to deteriorate into a mere replica of the market economy. In our study of the economics of socialism we must concentrate on this crucial problem: the planned character of the socialist system and its implications for individual freedom.

(4) LIBERAL SOCIALISM. Liberal (or democratic) socialism is characterized by public ownership of at least the strategically important material means of production, but also by free choice of consumption and of occupation. To simplify our discussion we shall assume that *all* material means of production are government-owned and that the producing units are managed by public officials who follow certain rules of behavior. These rules will be discussed in Chapter 16.

The decisive difference between liberal socialism and capitalism lies in the existence of government-owned industries which are not operated for private profit. If they exist at all, private firms will be enclaves in the socialist economy, just as nationalized industries are enclaves in the capitalist

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[12] *Ibid.*, p. 15.

market economy We can safely focus our attention, therefore, on public ownership and management of all the material means of production

Public management of all productive and distributive processes stamps the liberal socialist economy as a collectivist economy Liberal socialism wants to supplant capitalism because the latter's individualistic production is assumed to be "fundamentally blind, purposeless, irrational, and incapable of satisfying many of the most urgent human needs" [13] On this criticism of capitalism most socialists agree, though there is less agreement on the positive aims of the liberal socialist economy or on the ways by which these aims can be reached In Chapter 21 we shall see, e g , that the majority of the British Labor party has become rather cool toward nationalization The same can be said of social democratic parties in other non-totalitarian countries

Liberal socialism needs an authority which can set and accomplish social-economic ends—an authority which must have the power to direct the means of production according to some plan of action In this respect the blueprint of a liberal socialist economy is centralistic, though it need not be totalitarian

Nevertheless, the liberal socialist economy wants to permit free choice of consumption, not only in the sense of a choice among goods already produced, but rather in the wider sense of consumers' sovereignty This point is of major significance for differentiating various forms of collectivism Communism and fascism will not make the preferences of consumers the main criterion in production and in the allocation of resources They do not want unpredictable actions of consumers and workers to endanger the functioning of the central plan Free choice of consumption and of occupation must, in case of conflict, give way to the plan

Liberal socialism is in a more difficult position It must prove that consumers' sovereignty is compatible with the collectivist character of its economy, that individual freedom can be combined with public ownership of the material means of production, that central planning can and will follow the preferences of consumers

Not all writers who call themselves liberal socialist are equally sanguine concerning this important point R L Hall, for instance, says that the collectivist character of the socialist economy "involves the abandonment of free choice to the individual, at any rate as a fundamental liberty consumption and production must fit into a central scheme " [14]

Liberal socialism wants to achieve substantially greater equality of income distribution than is possible under capitalism The abolition of private property in the material means of production leads to greater equality through the elimination of "unearned' income As a rule, socialists no

[13] *Ibid* p 9

[14] R. L Hall, *The Economic System in a Socialist State* (London Macmillan & Co Ltd., 1937), pp 41-42

longer ask for complete equality; they realize that wage differentials are a necessary feature of an economy which wants to maintain free choice of occupation.

Capital accumulation becomes the function of the government. It is in the field of investment that we would find the main area of socialist planning. Investment in social overhead capital and "initial"[15] investment would not be guided solely by consumers' preferences, but care would have to be taken lest consumers' sovereignty get lost in this process of investment planning. In the last analysis the demand for investment goods would have to remain a "derived" demand, i.e., a demand induced by the demand for consumers' goods.

This enumeration of some of the most characteristic features of the liberal socialist economy shows that, as an economic system, liberal socialism finds its place somewhere between capitalism and communism. With capitalism it shares freedom of choice in consumption and occupation, the use of prices to direct production and to allocate productive resources, a certain amount of inequality of income distribution, and, as we shall see, a belief in the necessity of decentralization in the management of production. With communism it shares the more pronounced collectivist character of the system (i.e., the conscious pursuit of social-economic aims), public ownership of the material means of production, a more equalitarian income distribution, and the existence of a central economic authority which determines the rate of capital accumulation and somehow provides necessary guidance where automatic market forces cease to operate.

The liberal socialist economy hopes to combine the features of conscious social planning with individual freedom, so that a very large social product can be more equally distributed according to the wishes of consumers, and so that everybody can remain as free as modern production processes permit. Although these aims are fairly clear, it is less clear how the capitalist and collectivist features of liberal socialism are to be combined in a working order. What compromise is to be struck between freedom and planning, market exchange and public management?

(5) AUTHORITARIAN SOCIALISM (COMMUNISM). In the authoritarian socialist economy the central authority disposes of all the means of production (labor, natural resources, capital), autocratically determines the aims of the economy, directs production in a single all-inclusive plan, and regulates distribution. The freedoms enjoyed in the liberal socialist economy are abolished wherever they collide with the plan. Totalitarian socialism resolves the conflict between freedom and planning at the expense of freedom. Thus it offers, in a way, the more simple working model of socialism. If consumers can be forced to take what is produced, and if the members of the authoritarian socialist society can be made to

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[15] See footnote 5 to p. 90.

work where the plan demands their services, the general scheme of things is less complicated

We shall see, however, that even the authoritarian socialist economy needs a comprehensive accounting process If plan figures are expressed in monetary terms, as they must be if they want to be consistent and comprehensive, do these 'prices guide the plan or does the plan arbitrarily determine prices? We shall try to answer this question after we have studied the allocation process in the liberal socialist economy

The authoritarian socialist economy can be less extreme than this model It may, for instance, permit free choice of consumption or the allocation of labor by means of wage differentials Should, however, consumers' preferences become the guide of production, the authoritarian socialist system would change into a liberal socialist system

We take it for granted that the social economic systems which were designated as liberal are compatible with political democracy, while an authoritarian economy (whether communist or fascist) is the economic expression of a totalitarian political system A study which limits itself strictly to economics cannot prove or disprove this contention

CHAPTER 15

LIBERAL SOCIALISM AND FACTOR ALLOCATION

Introduction

The following paragraphs try to show that a socialist economy faces difficult problems of factor allocation. We shall see that the mere fact of public ownership of the material means of production and of government control of all investment funds does not do away with these problems. Investment funds, in particular, must be allocated consistently whether the economy is capitalist or socialist, liberal or totalitarian, consumer-oriented or centrally planned.

Emphasis will, at first, be placed on the liberal socialist economy because, in its consumer-oriented production, it is more similar to the capitalist market economy than to authoritarian socialism. But our results will be applicable to a large extent to authoritarian socialism. In changing from liberal to authoritarian socialism we change our assumption regarding aims and methods, but we must solve the problem of factor allocation in either case.

"Present" and "Past" Labor

We asume that in liberal socialism production is to follow the wishes of consumers as they express themselves in prices on consumers' goods markets. These markets are *real* markets where consumers spend their income in government stores freely and without rationing. Changing prices will indicate changes in demand or supply. But these price movements alone are not a sufficient guide for production. Commodity prices are relevant only in relation to costs; only a comparison of prices and costs can tell whether production should expand or contract in given industries.

Costs are determined by factor prices and techniques of production.

The price charged for a unit of a particular homogeneous factor must be the same for all industries using that factor if a rational factor allocation is to be achieved. An hour of labor of a given kind, for example, must be paid the same wage wherever used, otherwise equilibrium is not yet achieved and labor should be moved.

In capitalism factor prices are determined by demand and supply on factor markets How would they be determined in a liberal socialist economy?

If "present" labor[1] were the only factor of production the answer would be quite simple Since liberal socialism wants to maintain free choice of occupation, there must exist a *real* labor market on which the public managers of plants or industries somehow compete for different kinds of labor, and where laborers try to find the best-paid jobs for which they qualify In equilibrium the wage rate for each ("noncompeting") group will balance demand and supply

If wages of present' labor were really the only cost item that has to be considered, product prices would be determined by labor costs alone In equilibrium, commodity prices would just cover these costs and simultaneously equate demand and supply Production in different industries would expand and contract, and labor would shift until this result was achieved In equilibrium furthermore, the total wage bill would suffice to enable workers, as consumers, to buy the whole national product, for total wages, national income, national product, total costs, and the total of all commodity prices would all be equal The distribution of income, the allocation of labor to different industries, and the production of commodities would be determined by (a) the relative scarcities of different kinds of labor, (b) techniques of production and (c) tastes (and incomes) of consumers

The only difficulty encountered in this simple model concerns the monopolistic position of government managers in commodity markets and their monopsonistic power in labor markets The element of arbitrary price determination implied in the government's position as the single buyer of labor and the single seller of commodities can perhaps be overcome by establishing a rule that public managers must behave "as if" they were acting under real competitive pressure, or real competition could be permitted to exist among decentralized, semiautonomous government agencies

Let us now remove the assumption that only "present" labor need enter our cost calculation We assume that labor uses instruments and materials of production which are themselves scarce, since they are the result of earlier production processes and have to be accounted for at least as "past" labor

It would be naïve to assume that a socialist economy could disregard these capital goods in its accounting processes merely because the gov-

[1] As contrasted with "past labor See above, Chapter 11, p 126

ernment owns them and, accordingly, does not have to buy them from private sources. Certainly, Karl Marx would not have drawn this wrong conclusion. We remember that his labor theory of value counts past as well as present labor and that it does not make any difference to him how long ago a unit of labor was used. If all materials and instruments of production were the result of labor alone, we should still have to include raw materials and depreciation allowances in our cost calculations. Decisive would be the production costs in terms of socially necessary labor time, together with the periods of turnover.[2] Marx also points out that a portion of the social product serves as fresh means of production and remains social in the socialist society. This is capital accumulation at the expense of present consumption. Because both the replacement of old and the construction of new capital goods are necessary in socialism, part of the working force must be employed in the investment goods industry. This means that the workers in the consumers' goods industries must share their product with their comrades who produce raw materials and replace or create fixed capital. Obviously, then, the prices of consumers' goods must rise above their cost in terms of "present" labor if equilibrium between demand and supply is to be maintained. To put it differently, the aggregate value of consumers' goods prices must be substantially higher than the total wage bill in consumers' goods industries.

But not even the consideration of capital replacement and capital accumulation is sufficient if a proper allocation of the factors of production is to be achieved. Up to now we have acknowledged only that capital goods are as scarce as is the socially necessary labor used in their production, that capital goods are in need of amortization, and that resources have to be diverted from consumers' goods production to investment goods production if the economy is to grow. We have as yet failed to account for the *specific* scarcity of "capital," which must, however, be accounted for by a specific price over and above the original production cost of capital goods. This price is the rate of interest. To admit the need for an accounting process which uses an interest rate to allocate "capital" means, of course, that we deviate henceforth from Marxian ideas of socialist accounting.

The Scarcity of Investment Funds

But are we justified in the assumption that a liberal socialist economy requires a rate of interest for the consistent allocation of its resources? Is not the rate of interest a typically capitalist phenomenon which could be dispensed with in a socialist economy with public ownership of the material means of production?

Before we try to answer this important question, we can eliminate one

[2] See above Chapter 11, p. 126; Chapter 12, p. 133.

Since we are not certain that actual lending and borrowing would take place in a socialist economy, we shall use the term investment funds. Investment funds are not yet committed to any particular investment project. They merely embody the power to use productive resources for the production of investment goods.

It is of the greatest importance for any economic system that this generalized purchasing power, called loanable or investment funds, be put to the best possible use with reference to the aims of the economy. In the free market economy these funds are distributed according to the willingness and ability of borrowers to pay for their use, i.e., to pay a sufficiently high rate of interest. The interest rate, therefore, does not merely have the function of inducing the supply of savings. Even if individual savers were willing to forgo their unearned income from interest—even if they would save at zero rates of interest—interest would still be forced upon them by entrepreneurs competing to obtain the use of the limited supply of loanable funds. In normal times the demand for loanable funds for investment purposes would far exceed the supply at zero rates. We shall now have to find out whether this specific scarcity, which causes the price phenomenon called interest, is characteristic only for capitalism or applies equally to other economic systems.

The socialist may be tempted to argue that there is no such thing as a special scarcity of capital goods or of investment funds in socialism. Capital goods can be produced in increasing amounts if only we are willing to allocate more labor to their production. The only primary factor of production, the socialist might say is labor, and capital goods produced by labor are therefore only as scarce as the labor used in their production. And thus we seem to be thrown back once again on the labor theory of value.

There is, however, a serious flaw in this argument. It is by no means possible to requisition any desired quantity of labor (and of already produced capital goods and natural resources) for the manufacture of new investment goods. Assuming full employment, the output of consumers' goods has to be restricted if we want to increase the output of producers' goods. Of course, as we produce more investment goods, the productive power of the economy grows, and we are, therefore, able *in the long run* to produce more consumers' goods. It is indeed for this reason that we are always eager to introduce newer and better machines. But the increase in productivity from new investment does not occur until later, and in the meantime we must forgo even that satisfaction which could have been derived from spending the funds which we instead chose to save and invest.

Modern production processes are time-consuming and roundabout. The construction of capital goods takes time. In addition, many capital goods are very durable and render their full services only over long periods. Thus some time must elapse before there can be any increase at all in the satis-

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faction of consumers' wants, and a much longer time must pass before a given durable capital good has rendered all the services which it will be able to render during its lifetime This idea has been expressed by saying that the satisfaction of wants must be *waited for* We get more consumers' goods in the future, but at present, less than would otherwise be possible

Obviously, it would be absolutely impossible to allocate all our available resources to the production of capital goods As indicated in Chapter 2, this is one of those basic truths which are independent of the economic organization of our society and even independent of whether an individual lives in isolation or as a member of a social economy Let us demonstrate this for several different economic systems

An isolated farmer spends a large part of his time carrying water from the water hole He desires very much to dig a well but can never spare enough time to do the job The capital good, though very useful and in the long run laborsaving is beyond his reach because of the constant pressure of his daily struggle for existence

This farmer's economy is isolated and not part of a social economy, but his case is repeated by the economies of *poor countries,* like India, where millions live on a starvation level simply because they are not productive enough to be able to set aside a sufficient amount of savings for the production of other than immediately needed goods We meet here with a most crucial problem of economic development

In *an unplanned economy* total savings are determined by many factors Important among these factors are income level and income distribution As total income increases, consumption, though increasing in absolute figures, tends to decrease relatively, so that a greater proportion of the growing national income is being saved A higher level of consumption carries with it a growing willingness to forgo some consumption in the present in the hope of bettering the opportunities for consumption in the future We see again how saving is made possible only by limiting current expenditures on consumption

In *an authoritarian economy* the rate of accumulation is determined by the dictator, who can arbitrarily divide the available factors of production between consumers' goods and capital goods industries He may enforce a starvation level of consumption, but even he cannot ignore consumers' goods production altogether

The liberal socialist economy, too, will have to decide on a rate of accumulation, i e , it must somehow choose between present and future consumption It may desire both a more equal income distribution and a higher rate of capital formation and economic growth than would prevail under capitalism Here it faces a dilemma because a higher real income for the masses militates against a high rate of accumulation

We see that the problem of capital accumulation is essentially the same in all systems It is a conflict between the reluctance to cut down a possible

present consumption level and the desire to raise the standard of living in the future via increased production of capital goods. Assuming full employment, it is therefore not difficult to find the reason for that specific scarcity which leads, in capitalism, to the payment of a special price for the use of loanable funds.

Liberal Socialism and Interest

Now we must return to the question of whether the liberal socialist economy, too, would have to make use of interest charges for the purpose of adequate calculation and adequate factor allocation.

Since the rate of interest is a price, it must, like any other price, rest on the fact that the commodity or service for which it is paid is both useful and scarce. We have just seen that investment funds would be scarce in any social economy. Similarly, it is quite evident that capital goods are useful, that the efficiency of production increases when labor is supported by tools and machines. This fact has never been denied by socialist writers. If anything, socialists want to use more capital goods than capitalism manages to produce. We are therefore entitled to say that capital goods increase labor's efficiency, that it is desirable to have more capital goods, that investment funds are always relatively scarce, and that this situation is independent of the institutional framework of the economy, applying therefore to liberal socialism quite as much as to capitalism.

Since the liberal socialist economy cannot have all the capital goods that it would wish to employ, it has to be very careful to produce those which are the most useful. The question is not only how many capital goods should be produced during a period but also *which* capital goods should be selected, which industries should enjoy the advantage of being able to support their labor force with newer and better equipment. This second question is not yet solved when the central authority of the liberal socialist economy has decided on the total amount of capital goods production. The total can be determined arbitrarily, but the allocation of investment funds to different industries must not be decided in an arbitrary fashion. We have to know whether more steel, tractors, automobiles, roller bearings, or printing presses ought to be produced, and how far the expansion of production should go in each case. A *consistent* solution to this problem is possible only when we make each user of investment funds pay or "account for" the same rate of interest. This rate must be high enough to equate demand and supply both in the economy as a whole and in each industry.

Two objections might be made to these conclusions. It could be said that, since investment funds are expressed in terms of money, an inexhaustible amount of these funds could be supplied through the creation of money. But it is quite obvious that the resulting price inflation would be astronomical.

The second objection seems to be more reasonable It could be said that, in the socialist economy, the government simply limits the allocation of investment funds "according to plan" But this does not solve the question of securing the most economical use of a limited supply of investment funds Mere reference to a plan does not suffice, or it only leads to the question of how the plan can be designed to allocate resources in the best possible way to secure the ends of the plan Will not the planners themselves need the guidance of uniform prices?

In the liberal socialist economy we face the additional difficulty that the production process is supposed to produce the goods which consumers most want The only way, however, to establish an order of priority which accurately reflects the relative intensities of numberless consumer demands is to compare, for each good, the price which consumers are willing to pay and the cost of production. But costs must include not only labor costs, past and present, and expenditures for scarce natural resources, but also interest on the invested capital No production which is unable to cover interest charges should ordinarily be undertaken

Of course, the government of a liberal socialist country may decide to finance the production of certain socially desirable items at interest rates which are substantially lower than the equilibrium rate In capitalism too, this practice is often followed, as, for instance, when low cost housing is subsidized out of public funds in an attempt to counteract certain effects of an unequal income distribution

The liberal socialist may argue that his regime is less likely to violate the principle of free choice of consumption for such reasons because income distribution will be much more nearly equal than under capitalism This may be true On the other hand, as we shall see later on, the planned character of the socialist economy may lead to frequent deviations from the allocation which consistent pricing would have brought about If we insist on a central plan, the presumption is that deviations from consistent allocation (according to the changing wishes of the consumers) will become a permanent feature of the liberal socialist economy

How is the rate of interest to be determined where a genuine market for investment funds does not exist, where the government determines accumulation, and where the demand for investment funds comes exclusively from publicly owned and managed producing units?

A simple solution to this problem suggests itself The authorities could set a rate, say 5 per cent, and rule that all managers applying for investment funds would have to pay this rate A manager could pay the rate only if he were able to sell his product for a price high enough to cover his added cost of production

This may be the best solution In its favor we can point out that the unique uniformity of this price (as a percentage rate per period of time of the sum borrowed) lends itself to convenient central regulation It has

done so for a long time in central banking. More recently, not only has the interest rate been regulated as an instrument of monetary policy, but interest rates have also been kept artificially low to stimulate private investment, to reduce the cost of servicing the public debt, or to prevent losses by institutional investors.

Whereas in capitalism a cheap money policy constitutes a deviation from a market rate which could establish itself without the government's interference, we must remember that in socialism an arbitrary setting of the rate of interest would *always* be necessary.

In both capitalism and socialism the creation of credit can augment the supply of investment funds out of savings and thus lower the rate of interest which equalizes demand and supply; and in both systems inflation and deflation can be used as *ex post* indicators of whether the rate was set too low or too high. If the government wants to maintain an artificially low rate it can, of course, counteract inflationary effects through price controls, rationing, and priorities. Such an action would mean, however, interference with free consumers' choice.

Suppose that, with a given rate of accumulation, the rate of interest should be 8 per cent but that the government decides to use a 3 per cent rate. Some of the following consequences can be expected:

(1) The gap between the demand for and supply of investment funds is being filled through credit creation. Price inflation will ensue at high employment.

(2) Price controls can be used and consumption will be cut down by rationing rather than by price inflation.

(3) Since there are more investment opportunities at low than at higher rates, the allocation of investment funds will become arbitrary. In particular, resources will tend to be guided into long-term investments, where interest rates are more decisive as cost factor.

(4) The ensuing difficulties may eventually lead to the request that the tighter and consistent controls of a central plan be substituted for haphazard allocation among all those who are willing to pay the low rate of interest.

The Allocation of Natural Resources

We had to criticize Marx for his narrow definition of commodity, which excluded such gifts of nature as soil, water power, coal beds, etc. Because these gifts of nature are scarce in relation to the demand for them, their price must exceed the cost of labor and capital used in making them available for production processes or for consumption.

In a country where land of various qualities has to be used because land of the best quality is in short supply, the land of superior quality yields a rent income to its owner, whether he be private or public. The price of any product must cover its cost of production on the poorest land used for

its production, rent is the difference between this price and the lower production cost on better land Rent, therefore, is the equivalent of saved labor and capital cost It indicates the special scarcity of a production factor and must appear in some form in a consistent accounting process in any economy—including a socialist one

Profit and Risk

Most socialists agree that the decisions of public managers are no longer to be guided by the aim of maximizing profits In order to understand the implications of this attitude, we must analyze the different meanings of profit, profit motive, and profit maximization in capitalism

A C Pigou stresses the difference between profit and profit motive Profit is the difference between outlay and receipt, it implies the performance of a middleman's function Profit motive, on the other hand, is often simply synonymous with the desire for personal gain, the attitude which we called "acquisitiveness "[3] In this sense everybody would tend to "maximize his profits " Even in liberal socialism the worker or manager who would leave his job to accept a better one in another plant or industry would be acting in response to the profit motive But this is not what we usually refer to when speaking of maximization of profit We are then speaking of profit as an entrepreneurial income and the desire to make this difference between outlay and receipt as large as possible

What will happen to profit maximization in this narrower sense in a liberal socialist system? Will public managers be told to maximize profits, i e , to use the publicly owned land and capital at their disposal to earn the greatest possible returns for the government? Since all profits are the government's, the proposal would not be incompatible with the socialist character of the system Neither, however, would it serve the best possible allocation of the means of production with reference to consumers' preferences Maximization of profit certainly cannot be an end in itself in the liberal socialist economy The government does not need a maximum profit for purposes of capital accumulation, it can raise the necessary funds through taxation or other methods

But the fact that profits are made in a plant or industry is, in itself, an important indicator that production in this plant or industry should be expanded As production expands, profits will disappear Public managers should therefore use profits as an indicator to prove that their particular plants or industries are entitled to further expansion

Profits as indicators perform a necessary function in the liberal socialist economy They lead to the most desirable allocation of the nation's productive resources and are constantly eliminated by continuous reallocation of the factors of production For the managers of plants and industries, the

[3] A C. Pigou, *Socialism versus Capitalism* (London Macmillan & Co Ltd , 1937), pp 3 5

principle of profit "maximization" is actually reduced to the effort of keeping costs as low as possible. Profits, however they originate, should lead to an increased allocation of loanable funds for expansion. Even if profits are caused by a monopolistic position, this rule would apply, since expansion of production would eliminate our basic objection against monopoly—its artificial limitation of production.

In capitalism, profits are an indicator that equilibrium has not yet been fully achieved, and sufficient competition should thus lead to equilibrium of demand and supply at cost prices. Although liberal socialism may aim more directly at equilibrium at cost prices, temporary profits will appear in the process of approaching equilibrium. Indeed, such profits are the gauges necessary for steering the allocation of resources.

Legitimate (i.e., nonmonopolistic) profits may appear for two reasons. Either the managers concerned have met with greater demand than they had foreseen, or they may have developed methods of reducing costs. In both cases they can claim additional investment funds; in both cases they have the means of servicing the loan of additional funds.

Often the reduction of production costs will be impossible without the introduction of labor-saving machinery. In such cases investment funds must be obtained *before* the anticipated cost reduction can be achieved. Doubts may here arise whether the claimed increase in labor efficiency will actually materialize. In other words, the proposed investment is risky. Similarly, the *anticipation* of a growing or entirely new demand will involve risk. Where a growing demand is to be met, we could decide that this demand must first evidence itself in the form of higher product prices, of an excess of demand over supply. In the case of anticipated demand for a *new* product, however, this is not possible, and risks will have to be taken.

In the case of new production methods and new products it is conceivable that a "risk-premium" will be added to the rate of interest. Then only managers who believe they can cover this additional premium in their products' sales price (or through lowered costs) will be given the necessary funds. Certainly we cannot employ scarce resources in an entirely speculative way; on the other hand, we cannot stop probing new techniques and new markets.

If these decisions are difficult in consumers' goods industries, they become extremely complex in all earlier stages of production. These earlier production stages are, in some cases, far removed from the ultimate consumers' goods which they help to produce. Thus a demand for investment funds may come from managers who produce only parts of capital goods, and the capital goods, in turn, may not yet be used in the final stages of production. Furthermore, we know that the demand for investment goods in capitalism is subject to a "magnification" which can create substantial cyclical movements.[4] The explanation of this phenomenon does not suggest that it is limited only to capitalism.

[4] See above, Chapter 8, pp. 87-89.

Pricing and Planning

Socialists say that the instability of capitalism is caused by its reliance on the "blind" forces of the market, by the decisions of people who can see only a tiny section of the whole. The implication is, of course, that the socialist economy would enjoy the advantage of central planning.

But does central planning provide us with a substitute for market prices where no markets exist? Liberal socialists are for *de*centralization, they believe in as much freedom of management as can be made compatible with public ownership and they are aware that the necessary detailed knowledge of technological and other important data lies only with the men on the spot.

We should therefore assume that managers in a liberal socialist economy are *not* just fulfilling predetermined production quotas. Predetermined central planning is already excluded by the fact that production is ultimately to be guided by the consumer. But between consumers' demand and investment decisions in capital goods industries lies a big gap, which must be bridged either by planning an integrated production program or by consistently extending the pricing process from *real* consumer and labor markets (via a somewhat artificial capital market) into the area of capital goods production.

The theory of liberal socialism has to show how central planning can be squared with consumers' sovereignty and how consistent pricing is compatible with artificial markets where public managers deal exclusively with other public managers. Liberal socialists want to combine planning and pricing. From this combination they hope to derive a system which promises the advantages of both freedom and conscious collectivist planning.

The crucial economic problem of liberal socialism is the substitution of new methods of cost calculation and factor allocation for those which abolition of the capitalist system has removed. If it is impossible to maintain an adequate pricing process, *liberal* socialism may be doomed, because production can no longer follow the command of the consumer, and the central authority will have to rule by "arbitrary" decision.

If, on the other hand, a comprehensive pricing and accounting process can be created within a socialist framework, most problems indicated in this chapter will have found an answer, at least on the theoretical level. The most essential question is therefore whether or not the liberal socialist economy can reproduce the capitalist pricing process without the foundation of several typically capitalist institutions: private property in the material means of production, market exchanges between independent firms, actual competition, risk taking, and the profit motive.

But even if we were successful on this score, could the liberal socialist economy then still claim for itself the advantages of central planning?

CHAPTER 16

BLUEPRINTS FOR A LIBERAL SOCIALIST ECONOMY

Abstract Solutions

Socialist writers who have dealt with the problems which were enumerated in the preceding chapter can be divided into four groups.

A *first* group suggests that money be abolished and that necessary calculations be carried out *in natura,* i.e., in work hours, tons, kilowatts, etc. Only writers who are completely bewildered will try to "improve" the social-economic system by depriving it of the services of a common unit of account, the *sine qua non* for consistent factor allocation. These proposals are not worth studying.[1]

A *second* group proposes abstract solutions in the hope that its proposals could somehow be made to work in the real world. A brief discussion will show that these blueprints have not managed to bridge the gap between theory and reality.

A *third* group recommends a practical trial-and-error solution, and it is with this proposal we shall be mainly concerned in the present chapter.

The *fourth* group, too, suggests a practical approach, but since it is emphasizing central planning at the expense of consumers' sovereignty, its proposals will be discussed in Chapter 18—as an authoritarian solution.

The proposals we shall discuss first are those of the second group, i.e., abstract schemes which merely indicate the problem but do not offer any really convincing recommendations for a practical solution.

Some socialists think it possible to provide for adequate calculation in

[1] See, however, the criticisms of the following: T. J. B. Hoff, *Economic Calculation in the Socialist Economy* (London: William Hodge and Company, Ltd., 1949), Chap. IV; Franz Haber, *Untersuchungen über Irrtümer moderner Geldverbesserer* (Jena: Gustav Fischer, 1926); Arthur W. Cohn, *Kann das Geld abgeschafft werden?* (Jena: Gustav Fischer, 1920).

socialism by reference to the possibility of an "imputation of quantitative significances" Eduard Heimann, for example, says that the valuation of consumption goods is "reflected" in the valuation of the factors of production that market prices of consumers' goods are "transmitted" through all the stages of production, that the values of consumers' goods and of the factors of production are connected by an "elastic string," and that it is consequently possible, even if private property in the means of production is abolished, to "calculate the significance of each factor in the manufacture of goods if the prices of the products are given" [2]

This is not a solution of the allocation problem, it is not even a correct statement of the issue What we need is not an *ex post facto* imputation of commodity prices but an answer to the question of what costs are to be incurred in view of a given demand for consumers' goods Cost data can be obtained only from an *independent* and consistent valuation of the separate factors of production, which can be combined in an infinite variety of ways T J B Hoff rightly points out that factor values cannot be imputed exclusively from the values of the final products "This could only be done if the factors of production were always used in fixed proportions and they were only used to produce a single product" [3]

For a practical solution it is also not enough to *imagine* as Carl Landauer suggests "each good changed from one employment to another until it has actually obtained its highest attainable significance" [4] Robinson Crusoe can perform this task because he knows all the relevant data and his mind registers instantly all the changes of these data But when the aggregate demand in the social economy rests on innumerable individual priority scales, when the division of labor is carried to the extreme, when the enormously complex process of production and distribution is beyond the power of comprehension of any individual or even of a central planning board, then any imputation other than through a comprehensive pricing process is impractical

It has been suggested that the factor allocation could be handled by a system of simultaneous equations which could be solved and would, in one tremendous comprehensive calculation, determine the interrelated prices of consumers' goods intermediate goods, and the factors of production For instance Gustav Cassel's equations have been used for this purpose [5] But it is quite obvious that these equations do not provide us with a prac

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[2] Eduard Heimann *Mehrwert und Gemeinwirtschaft kritische und positive Beiträge zur Theorie des Sozialismus* (Berlin Robert Engelmann 1922), *Kapitalismus und Sozialismus* (Potsdam Alfred Protte 1931)

[3] Hoff *op cit* p 123

[4] Carl Landauer *Planwirtschaft und Verkehrswirtschaft* (Munich Duncker und Humblot 1931) p 119

[5] See below Appendix to Chapter 3 pp 320 328 For a solution based on the Casselian equations see Klaire Fisch *Wirtschaftsrechnung und Verteilung in zentralistisch organisierten sozialistischen Gemeinwesen* (Wuppertal Elberfeld 1937)

tical solution of the allocation problem in liberal socialism. Cassel knew that his equations could not be solved, for the demand functions are unknown.[6]

Enrico Barone uses a system of equations to show that the Ministry of Production in a collectivist state would have to use "all the economic categories of the old regime . . . : prices, salaries, interest, rent, profit, saving, etc."[7] He comes to the conclusion that "it is conceivable . . . that with a vast organization for this work it would be possible to collect the individual schedules for every given series of various equivalents, including the premium for deferred consumption." But, he continues, "it is frankly *inconceivable* that the *economic* determination of the technical coefficients can be made *a priori,* in such a way as to satisfy the condition of minimum cost of production. . . ."[8]

Vilfredo Pareto, who like Cassel and Barone, uses a system of simultaneous equations, says,

> It may be mentioned here that this determination has by no means the purpose to arrive at a numerical calculation of prices. Let us make the most favorable assumption for such a calculation, let us assume that we have triumphed over all the difficulties of finding the data of the problem and that we know the ophélimités of all the different commodities for each individual, and all the conditions of production for all the commodities, etc. This is already an absurd hypothesis to make. Yet it is not sufficient to make the solution of the problem possible. We have seen that in the case of 100 persons and 700 commodities there will be 70,699 conditions (actually a great number of circumstances which we have so far neglected will still increase that number); we shall therefore have to solve a system of 70,699 equations. This exceeds practically the power of algebraic analysis, and this is even more true if one contemplates the fabulous number of equations which one obtains for a population of forty millions and several thousand commodities. In this case the roles would be changed: it would not be mathematics which would assist political economy, but political economy would assist mathematics. In other words, if one really could know all these equations, the only means to solve them which is available to human powers is to observe the practical solution given by the market.[9]

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[6] See Appendix, footnote 3 to p. 323.

[7] Enrico Barone, "The Ministry of Production in the Collectivist State," in *Collectivist Economic Planning,* ed. by F. A. Hayek (London: George Routledge & Sons, Ltd., and Kegan, Paul, Trench, Trubner & Co., Ltd., 1935), Appendix A, p. 289.

[8] *Ibid.,* p. 287.

[9] [Vilfredo Pareto, *Manuel d'économie politique,* 2nd ed., 1927, pp. 233-234.] Quoted in F. A. Hayek, "Socialist Calculation: The Competitive 'Solution'," *Economica,* New Series, VII (1940), 125-126.

It is interesting to note that the three authors, Cassel, Barone, and Pareto, whose equation schemes have been used to prove the feasibility of adequate accounting in socialism, are all convinced that their schemes do *not* offer a practical solution for the problems of socialist factor allocation

H D Dickinson, too suggests a mathematical solution "Given, at each end of the chain of production," he says, "a free market for finished goods and for productive services, the prices and the quantities that would exist if the intermediate goods were sold in a market, could, theoretically, be determined" [10] What does "theoretical" mean in this case? Since Dickinson's book wishes to prove only "that, as far as pure economics is concerned, a socialist economy is at least theoretically possible," [11] we cannot contradict him However, Dickinson tries to show in detail how a socialist economy would work and how it would be quite superior to capitalism Furthermore, like Cassel he abandons the abstract nature of his system by letting his equations rest on the data produced by actual markets "at each end of the chain of production" Obviously, then "theoretical" does not mean "abstract" and Dickinson asserts that we could solve our problem by solving thousands or millions of equations

When Lionel Robbins expressed doubts that this method was workable,[12] he was told by Oskar Lange that the central planning board of the socialist economy would not have to solve millions of equations, because this task, obviously considered too big by Lange, would be made unnecessary through a method of trial and error [13]

Dickinson admits that the method of trial and error, which will be discussed below, would not be "replaced entirely by centralized price determination based on the solution of thousands of simultaneous equations The reason is that the data themselves, which would have to be fed into the equation machine, are continually changing" [14] In other words, the expressions for consumers' decisions as a function of commodity and factor prices as well as technological coefficients, cannot be ascertained through the equations themselves

These considerations are of the greatest importance for the theory of socialism because they show that pricing in socialism has to rest on actually known prices whether they are supplied by the functioning of real markets or are set by the government

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[10] H D Dickinson *Economics of Socialism* (New York Oxford University Press 1939) p 104

[11] *Ibid* p 13

[12] Lionel Robbins *The Great Depression* (London Macmillan & Co Ltd 1935), p 151

[13] Oskar Lange and Fred M Taylor, *On the Economic Theory of Socialism* (Minneapolis University of Minnesota Press, 1938), p 88 Copyright 1938 by the University of Minnesota

[14] Dickinson *op cit* p 104

The Trial-and-Error Method

If the liberal socialist economy is to rest on a comprehensive pricing process, this pricing process must be more than an abstract scheme. Each person—consumer, worker, plant manager, industrial manager—must have data on which to base his decisions. Such a pricing process must be very similar to the price mechanism of the capitalist economy. The basic problem of liberal socialism in the economic field is the creation of such a pricing process within the structural environment of socialism. Where real markets exist we can expect to find equilibrium prices which equalize demand and supply. Where no real markets exist prices can be set arbitrarily by government authorities.

On the basis of a complete set of prices the different members of the liberal socialist economy can make their decisions. They will buy whichever commodities they desire to buy, they will work where their skills are offered the highest wages; and managers will produce only commodities which consumers want to buy and will keep costs of production as low as possible.

Once all these decisions have been carried out, it will be seen by the managers that the original prices will have to be changed. Real market prices may change automatically, while set prices will have to be adjusted by the central authority or by the managers. Where it becomes obvious that at the set price the amount demanded exceeds the amount supplied, the price must be raised; where unsold goods prove that the price was set too high, the price must be lowered.

After these changes have been made, the members of the liberal socialist society act once more according to their interests or—in the case of managers—according to rules of behavior prescribed by the government. This time the result should be more satisfactory, unless changes in the basic data have occurred (e.g., technological changes). Without such exogenous changes the system could gradually find an equilibrium position in which all factors of production are employed, consumers get the commodities they desire, and factors of productions are allocated among different industries in such a way that demand and supply are equated at prices which cover production costs.

This interesting proposal, which was made by Oskar Lange, D. H. Dickinson, and other liberal socialists, has been attacked from two sides. Some writers contend that a system of partially artificial pricing would not lead to the desired results. The capitalist economy, they argue, rests on the profit motive and on competition, and these driving and checking forces could not be reproduced by the socialist economy. The other attack comes from authoritarian socialists, who emphasize central planning. A system of

trial and error implies, according to these critics, a degree of decentraliza tion which would not leave enough room for planned action

Basically, the trial and-error system is very simple and seems to answer Mises' criticism Mises, we remember, argued that (1) a comprehensive pricing process is necessary for rational economic behavior, (2) the pricing process has to rest on markets for all goods and for all the different factors of production, and (3) markets can exist only under conditions of private property, characterized by the buying and selling of independent private consuming and producing units who are driven by the acquisitive motive and kept in check by a sufficient amount of competition

Dickinson, Lange, Dobb, and others contend that Mises and his followers used the term 'price" in the narrower meaning of *market* price, whereas it can also be used in the wider sense of ' terms on which alternatives are offered " [15] We are told that only prices in this wider sense are indispensable for the choice between alternatives Maurice Dobb criticizes both Mises and the present writer for a "confusion between two distinct things between the process of calculation and the source of the data for calculation " [16]

Before we continue our study of the trial and-error blueprint we must emphasize that liberal socialists do not want to set up a highly centralized system On the contrary, they favor decentralization because they are aware of the fact that no central authority can possibly know, and compre hensively interrelate, all the relevant data If it could, it would not need a comprehensive accounting process, it would act like Robinson Crusoe Prices mean nothing to Robinson because he can compare the intensity of his wants and allocate the means of production in one decision The problem of allocation in a modern liberal socialist economy, however, is far too big to be solved without the aid of a pricing process and without a suffi cient degree of decentralization

L D Trotsky stated the problem as follows

> If there existed the universal mind, that projected itself into the scien tific fancy of Laplace, a mind that would register simultaneously all the processes of nature and of society, that could measure the dynamics of their motion and could forecast the results of their inter actions such a mind, of course, could a priori draw up a faultless and an exhaustive economic plan beginning with the numbers of hectars of wheat and down to the last button for a vest In truth, the bureaucracy often conceives that just such a mind is at its disposal, that is why it so easily frees itself from the control of the market , but in reality the bureaucracy errs frightfully in this appraisal of its spir-

[15] Lange and Taylor, *op cit* p 60

[16] Maurice Dobb Review of *Collectivist Economic Planning* ed F A Hayek in *Economic Journal* XLV (1935) 532 535

> itual resources. . . . The innumerable living partieipants of eeonomy, State as well as private, eollective as well as individual, must give notice of their needs and of their relative strength not only through the statistical dcterminations of plan commissions but by the direet pressure of supply and demand. The plan is ehecked and, to a considerable measure, realized through the market. The regulation of the market itself must depcnd upon the tendeneies that are brought out through its mcdium. The blueprints produced by the offiees must demonstrate their economic expediency through eommercial ealeulation.[17]

The trial-and-error blueprint of the liberal socialist eeonomy establishes a decentralized system. The aetors on the eeonomic stage are millions of consumers and workers and thousands of public managers. This system has two genuine markets, that for eonsumers' goods and that for the serviees of labor (including managerial labor). Sinee there is no market for producers' goods and for produetive serviees except labor, "the prices of eapital goods and produetive resourees outside of labor are thus prices in the generalized sense, i.e., mere indiees of alternatives available, fixed for accounting purposes." [18]

The working principles of this system are as follows: Consumers, workers, and managers make their decisions on the basis of given priees. Consumers and workers will act very much as they acted under eapitalist conditions. The principles and motivations of their actions are therefore known to us. Self-interest will be sufficiently strong, and acquisitive tendeneies will express themselves through price movements on genuine markets—provided that the managers who sell consumers' goods and buy the serviees of labor are duty-bound not to use their monopolistic and monopsonistie powers. This brings us to the most important problem of deeentralization in a liberal socialist economy—the behavior of produetion managers.

How Are the Public Managers to Act?

The designers of liberal soeialist blueprints are disappointingly vague when they diseuss the rules of behavior for publie managers. This vagueness is understandable, however, because here lies the erueial point of eonfliet between pricing and planning, between freedom and central eontrol. Here, also, it beeomes obvious that the soeialist economy ean no longer follow the eapitalist model. Publie ownership of the material means of production eliminates, where it exists, individual private enterprise; and government management must therefore be substituted for the aetivities of the eapitalist entrepreneur.

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[17] L. D. Trotsky, *Soviet Economy in Danger* (New York: Pioneer Publishers, 1933), pp. 29-33.

[18] Lange and Taylor, *op. cit.*, p. 73.

At this point socialist writers argue, first of all, that the difference between socialist and capitalist management is not so great as it may appear Since government ownership and management is, mainly, to apply to certain strategic fields within industry, transportation, commerce, and banking, it is suggested that we should compare public managers in liberal socialism with managers of large corporations in capitalism

We have already emphasized the importance of the division of ownership and control in Chapter 5 Paul Sweezy concisely describes the resulting change in capitalist leadership as follows

> The typical capitalist enterprise outgrew the personal entrepreneur His functions and responsibilities were now split up among a number of more or less separate groups The function of the capitalist—to provide capital—was assumed by shareholders whose only concern was the state of the corporation s profit and loss account and the price of its shares The functions of employer of labor, organizer of production and salesman of commodities were taken over by a hierarchy of salaried officials, engineers and accountants, who became increasingly specialized and expert in their respective spheres of activity Final authority in a corporation of this sort lies with a board of directors, nominally elected by the body of shareholders but actually chosen by a complex process in which not only those who exercise capitalist and entrepreneurial functions but also outside groups (such as bankers and important customers) normally play a part [10]

This is a realistic description of the situation prevalent in parts of industry which are of strategic importance and liable to be socialized first The internal structure of a socialist corporation can, therefore, be modeled after the somewhat bureaucratic setup of the large capitalist corporation For this reason we assume that the problems of *internal* functional division of labor can be solved in a liberal socialist plant or industry Many of the specialized functions can be performed by hired experts, who need no more incentive for competent work than that which the labor market can provide in the form of attractive salaries This statement is true for engineers, production managers, sales managers, accountants, etc As for the function of the stockholder, we have already seen that it must be performed by the government We should note, however, that the capitalist stockholder has performed more than the function of saving, he has, in addition, decided *where* to invest his funds and what risks to take Although the government can arbitrarily decide the total amount of accumulation, arbitrary decisions are no longer possible when we come to the problem of allocating investment funds to different industries This allocation has to be consistent Investment funds must go to those industries where the productivity of

[10] Reprinted from *Socialism* by Paul M Sweezy p 209 Copyright, 1949 Courtesy of McGraw Hill Book Company, Inc.

capital is greatest. In the end the marginal productivity of capital should be the same in all branches of industry.

This problem of allocation cannot be waived aside by mere reference to the internal structure of the modern capitalist corporation. It is the most crucial problem—the problem of which industry is to expand and which is to contract.

Whoever makes these most fundamental decisions in capitalism supposedly acts according to the profit motive. The answer to the question of expansion and contraction will be provided by those who are eager to purchase or produce additional capital goods and those who are willing to risk their funds in the venture. Characteristic of the capitalist solution is, in any case, the absence of a central investment plan.

The problem of the socialist economy is to substitute for the profit motive certain rules of behavior which the public managers of plants and industries have to follow.

In Chapter 15 we saw that public managers will not be told to maximize profits; they are to use profits as a signal that production is to be expanded. But we had to realize that this rule is deceivingly simple, that it cannot easily be applied where *new* products and *new* techniques are in question. In these cases it is impossible to request allocation of loanable funds on the basis of known, demonstrable profits. Allocation of resources in expectation of *future* profits and for the elimination of *anticipated* gains is a difficult matter; it involves risks. These difficulties and uncertainties are particularly great in the large area of intermediate goods production, which is precisely the area where the capitalist solution (based on genuine markets) has to be replaced by the setting of accounting prices and where private initiative and risk taking are first to give way to public management. Here, too, will be found the greatest emphasis on central development planning.

Liberal socialist writers are vague when they come to this crucial issue—the question of whether public managers are to follow a predetermined development plan or whether decentralization can be carried far enough to permit independent investment decisions by these managers.

Liberal socialists are aware of the fact that detailed allocation of every bolt and screw by the central planning board is an impossibility, that decentralization is of vital importance, and that the managers on the spot must be free to make whatever adjustments in production are necessitated by changes in techniques, demand, and factor supply. Those who advocate the trial-and-error method want to express the effects of these changes in price changes and, temporarily, in profits and losses.

The *industrial* manager is a socialist functionary who has no counterpart in the capitalist economy. Under normally competitive conditions we do not find companies which control a whole industry. The economic unit in capitalism is the firm, and it is to be assumed that the firms in an industry act independently.

The liberal socialist economy, on the other hand, must have industrial managers The question of whether a new plant should be added to already existing producing units in a given industry cannot be decided on the basis of profit expectations of independent firms The investment funds come from the government, and the central planning board needs the advice of men on the spot The request for new producing units in an industry must come from the specialist who, on the basis of cost-price calculations, can establish a claim to allocation of further funds The manager of an industry must know the cost schedules of the different plants, he must be able to decide whether it is better to enlarge existing plants or to build a new unit, he must be able to control the actions of the plant managers, his interest must transcend that of an individual producing unit The plant managers will be permitted to handle problems of a more local character, but the basic economic unit of the liberal socialist economy is the industry

Questions of Cost Accounting

Oskar Lange proposes that the managers of socialist plants and industries should act *as though* they were capitalist entrepreneurs in a competitive market We recall that the conditions of pure and perfect competition in capitalism are that (a) the seller cannot influence the market price, and (b) everybody is free to enter the industry [20] Lange requests, accordingly, that the central planning board should impress on managers, as an *accounting* rule, that "all accounting has to be done *as if* prices were independent of the decisions taken For purposes of accounting, prices must be treated as constant, as they are treated by entrepreneurs on a competitive market " [21] The industrial manager must see to it that the industry produces "exactly as much of a commodity as can be sold or 'accounted for' to other industries at a price which equals the marginal cost incurred *by the industry* in producing this amount " This rule performs "the function which under free competition is carried out by the free entry of firms into an industry or their exodus from it i e , it determines the output of an industry " [22] The plant managers must choose the methods of production "which minimize average cost" and "equalize marginal cost and the price of the product " [23]

To explain Lange's requests, we have to recall how production adjusts itself to demand in capitalism under conditions of pure and perfect competition At first we assume a constant cost industry In a constant cost industry, production can be expanded through the addition of new plants whose

[20] See footnotes 3 and 10 to Chapter 7

[21] Lange and Taylor, *op cit*, p 81

[22] *Ibid* p 77

[23] *Ibid* p 78

average and marginal costs are the same as those of already existing producing units.

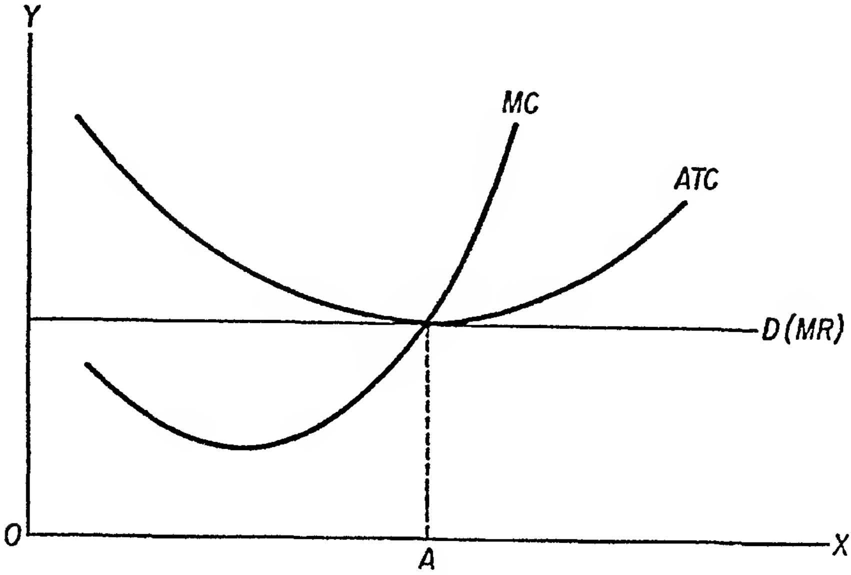

FIGURE 1

Figure 1 illustrates the production costs incurred by a firm (plant). *ATC*, the average total cost of production, or cost per unit of output, is the total cost divided by the number of units. Without entering into a detailed cost analysis, we assume that the typical producing unit has one production volume (*OA*) where average total costs are at a minimum. This is, technically speaking, the optimum. The reason for this assumption is *the law of diminishing returns*, which can be summarized as follows:

> An increase in some inputs relative to other comparatively fixed inputs will cause output to increase; but after a point the extra output resulting from the same additions of input will become less and less; this falling off of extra returns is a consequence of the fact that the new "doses" of the varying resources have to work with less and less of the constant resources.[24]

It should be noticed that this law of diminishing returns is quite independent of the social structure of the economy and applies to socialism as much as to capitalism.

The marginal cost curve *MC* is derived from the same set of data as the average total cost curve *ATC* of Figure 1. If we produce 10 units at a total cost of $200 and 11 units at a total cost of $209, the average total cost

[24] Paul A. Samuelson, *Economics* (New York: McGraw-Hill Book Company, Inc., 1948), p. 23.

changes from \$20 to \$19 as we expand production The marginal cost, or the cost of producing an extra unit, is in our example, \$9, viz, the total cost of producing 11 units (\$209) minus the total cost of producing 10 units (\$200)

Whenever marginal cost is lower than average total cost, average total cost decreases as production expands, because the inclusion of this extra (or marginal) unit lowers the average, but as soon as it costs more than the average total cost to produce an additional unit, i e, as soon as the marginal cost exceeds the average total cost, average total cost must rise From this we must conclude that marginal cost and average total cost are identical at the volume of output that minimizes average total cost To put it differently the *MC* curve must intersect the *ATC* curve at the latter's lowest point, and to say that an entrepreneur or manager should produce at lowest cost means that he should choose as his output (*OA*) that quantity shown at the intersection of the *MC* and *ATC* curves

But Lange's liberal socialist managers have not only to produce up to the point where average total cost is minimized They must, in addition equalize marginal cost and the price of the product In Figure 1 they have obeyed this rule because the price (*D* or *MR*) just covers the lowest average cost of production Because we assumed that cost curves are identical for all plants which constitute an industry, we must conclude that, in equilibrium, the price must correspond to the lowest average total cost Where it is higher, profits would appear, where it is lower, losses would be incurred, and expansion or contraction of production would lead back to equilibrium This would be the result of pure and perfect competition in capitalism In liberal socialism the industrial manager would have to see to it that the needed adjustments are made In all plants production will be carried to the point where average total cost, marginal cost, and price are identical, and in the industry the number of producing units and the total output will be so chosen that, with a given demand for the product, the price corresponds to the lowest average total costs in all the identical plants

The case of an increasing cost industry is more controversial Here costs will differ from plant to plant Take, for instance, the case in which land is of varied quality As we add more producing units, we find that their average total costs are higher than those of the older producing units In capitalism the entry of new high-cost firms is possible only if and when the price of the product covers the minimum cost of the marginal firm At this price, already existing firms will be able to expand production They will produce up to the point where marginal cost is equal to the price But since the minimum average total cost of the already existing firms is lower than the market price, total revenue will be higher than total cost in these firms If the advantages which the older firms enjoy cannot be duplicated by the newcomers, these "profits" cannot be eliminated Because of their perma-

nent character we call them "rent." Rent is the result of certain permanent advantages which enable some firms to produce a given output with less labor and capital than the marginal producer.

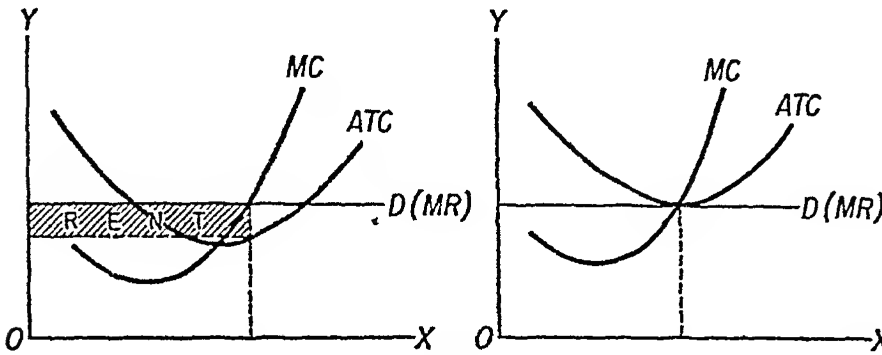

FIGURE 2

Figure 2 illustrates this situation.

If the same situation exists in a liberal socialist economy, how are industrial managers to act? Two solutions suggest themselves:

(1) The industrial manager can follow the capitalist model and lay down the rule that the plant managers should produce up to the point where marginal costs are equal to price. Only in the marginal plant would marginal cost at this output be equal to average total cost. All other plants would earn an extra revenue, rent, which would be turned over to the government.

(2) The industrial manager could treat the whole industry as a unit, with costs figured as industrial averages. In this case the low-cost units would permanently subsidize the high-cost units and, in equilibrium, total cost and total revenue would be the same for the industry as a whole.

Unquestionably the liberal socialist system could use method (2) and instruct the managers of increasing-cost industries to pass on to consumers the rent income from those unique advantages which some of the producing units enjoy. At first this may seem the logical thing to do. The industry is the economic unit in the socialist economy and is treated as such in this method of accounting in terms of industrial averages.

Nevertheless, method (1) should be used for the following reasons: If we assume full employment of the factors of production throughout the economy, we see at once that the consumer does not necessarily gain, because production in the individual industries concerned is driven further under method (2) than under method (1). Since we assume full employment, less of something else will have to be produced in such a case. The rent which goes to the government under case (1) will either lead, through increased accumulation, to production of producers' goods or be distributed via social-dividend payments or lower taxes and thus cause increased con-

sumption The question of accumulation need not interest us at the moment. Let us assume, therefore, that the consumer may choose either a higher money income, according to method (1), or lower prices for articles produced under increasing-cost conditions, according to method (2) The basic principle of free consumers' choice clearly favors method (1) This method also recommends itself because it makes the consumer pay a price equal to marginal cost and therefore equal to the alternatives sacrificed Rent can be interpreted as the price paid for scarce production advantages which enable us to save labor and capital Finally, method (1) recommends itself because it leads to the application of one and the same principle to all industries and to all plants A system in which many industries would have to use sliding cost averages would face rather formidable problems of cost accounting

When industrial output can be increased under decreasing-cost conditions, the lower costs should be the deciding ones even if the average total costs of smaller, older, and obsolete plants cannot be fully covered This case is the opposite of the situation just discussed Again two policies are possible In policy (1) production is continued until marginal cost in the new plants is equal to price Since marginal cost is now lower than average total cost in the older plants, losses will be incurred in these plants In policy (2) production would stop when average cost for the industry equals price In this case the low-cost plants subsidize the high cost units To be consistent, we again have to choose policy (1) Socialist writers, as well as A C Pigou, have argued that the negative rents or accounting losses incurred under rule (1) should be covered by permanent subsidies These subsidies could be taken from a marginal cost equalization fund into which would be paid all positive rents arising in increasing-cost industries [25]

Lange's suggestions are based on the assumption that pure and perfect competition can be imitated by providing rules of behavior for socialist managers However, the theory of monopolistic (or imperfect) competition has shown that the case of pure and perfect competition is not too often found in capitalism This means that many capitalist entrepreneurs know quite well that they can sell more at lower prices, that the demand curve, as they see it, is not of perfect elasticity, and that the demand and marginal revenue curves are not identical

In the above discussion of purely competitive cases we assumed a demand which appears to the businessman to be perfectly elastic He assumes, therefore, that at the given price (which he cannot influence) he can sell whatever quantity he produces If the price is one dollar, he can sell any additional unit for one dollar, and the demand curve (a straight horizontal line) is identical with the marginal revenue curve (*MR*)

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[25] Dickinson *op cit* p 108 Lange and Taylor, *op cit* p 77, A C Pigou *The Economics of Welfare* 4th ed (London Macmillan & Co Ltd 1938), Part II Chap 11

Lange sought to have this situation imitated by his breathtakingly simple request that the managers should behave *as if* the price were unalterably given. Applied to industries which decidedly are *not* purely competitive, this rule seems extremely artificial, because industrial managers know that changes in output and price must instantly affect the amount demanded.

In many cases the producing units are far too big to permit a competitive solution, as indicated above; i.e., the question of how much to produce is not solved by the addition or subtraction of small producing units but rather by changes in the output of existing industrial plants.

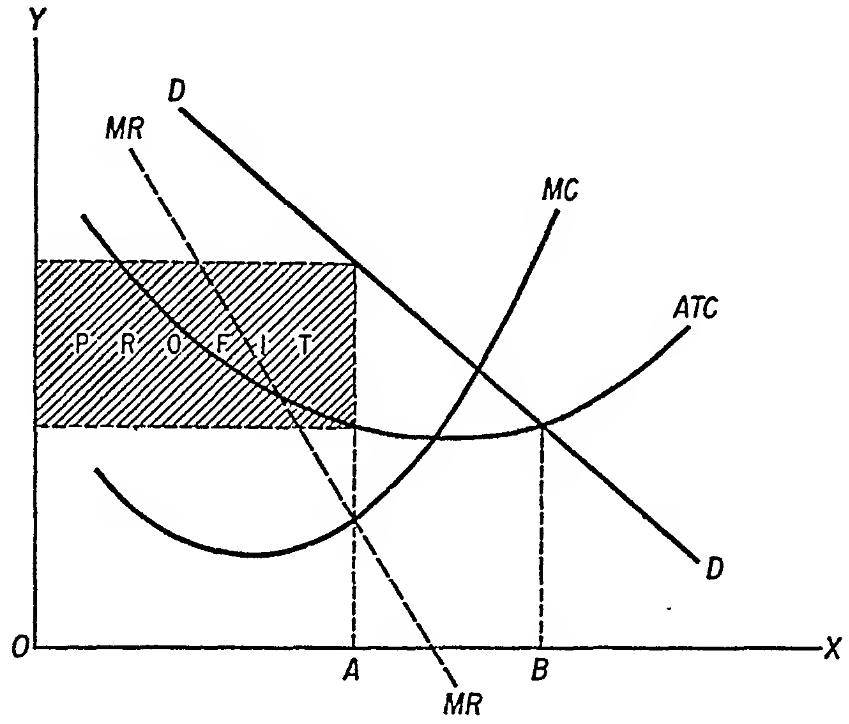

FIGURE 3

Figure 3 illustrates this case. The capitalist businessman will, of course, produce up to the point where the marginal revenue curve intersects the marginal-cost curve, since the firm's profits are increased (or losses reduced) as long as each new unit produced and sold adds less to total cost than to total revenue.

How is the industrial manager in liberal socialism to behave? We may assume that he is fully aware of the situation, knowing that his sales depend on the price and, also, that his producing units are too big to permit the infinitesimal adjustments under Lange's *as-if* method.

Figure 3 suggests two possibilities for the manager's course of action. He can either imitate the capitalist solution, produce amount *OA*, and hand

the profits over to the government, or he can expand production to point B, i e, until the average total-cost (ATC) and demaod (DD) curves intersect, tbus achieving equality of total-cost and total revenue

We need not come to any definitive conclusion on this point All the above rules of behavior for industry and plant managers are of relatively minor importance Depending on how we formulate the rules, somewhat more or less of a commodity will be produced But, at full employment, we produce more of commodity A only at the expense of commodity B Far more important are the practical prnblems of management relatioos among managers and between managers and planning authorities, the psychological practieality of the proposed "as if" behavior, proteetion agaiost monopoly power, the degree of decentralization, the ioitiative of managers, dangers of bureaucratization, the possibility aod importance of auditing, etc Next to (aod connected with) the questions of accounting, allocation, and pricing, these management problems are the most controversial issue of liberal socialist economics They will be dealt with in Chapter 17 First, however, we have to study the functions of the central planning board io the liberal socialist economy

Functions of the Central Planning Board

The central planniog board of the liberal socialist economy has the following functions

The planning board determines the rate of accumulation, i e, it draws the dividing line hetween producers' goods aod coosumers' goods production In saying that this decision is an arbitrary one, we do not want to imply that the political processes hy which this decision is made cannot be democratic "*Arbitrary*" means *only that the decision to accumulate is* no longer dependent on the willingness of individual members of tbe community to save Accumulation can take several forms (a) Individuals may still be free to postpone consumption, i e, to save (b) Money earned by the government in form of interest, reot, or profit can be set aside for accumulation (c) Government revenue from taxation may exceed the cost of current communal services (d) The creation of new money may cause price inflation and thus decrease tbe purchasing power in the hands of consumers From all these sources may flow investment funds, wbich are available for capital goods production In addition, the goveroment will receive amortization funds, which do not necessarily have to be invested in the plant or industry from whieh they came, rather, they should be added to the total fund and allocated according to the same general principles which apply to the distributioo of iovestment funds among different industries

Closely related to the problem of accumulation is the problem of income distributioo If the government paid its expenses and financed accumulatioo

exclusively out of interest, rent, and profit, no taxation would be required, and citizens would receive their wage income in full. While this situation would establish a very simple model, it would be just as arbitrary as any other method of determining the relative proportions of accumulation and consumption.

As far as the distribution of income among members of the liberal socialist society is concerned, the central planning board could not act entirely arbitrarily. The labor market fulfills an important function, and the income distribution established by demand and supply on the labor market must not be "corrected" to such a degree that the labor market would cease to function. If a social dividend is paid, it must *not* be distributed with the intention of leveling the inequalities which the labor market creates. Nobody would greatly care what wages were paid in a given field if he could expect relatively low wages to entitle him to a relatively larger share in the social dividend. That partial equalization of wage incomes is possible, however, is clearly indicated by the application of progressive taxation to earned income in capitalism.

The central planning board must perform a very important function in the pricing process. Many prices are accounting prices which are arbitrarily set and subsequently changed when demand exceeds supply or supply exceeds demand. Even consumers' goods prices and wages are influenced by the central planning board. The demand for labor comes from public managers, and consumption goods are sold exclusively in public stores. Perhaps the managers of these stores are permitted to change prices frequently, but it is possible that this right is reserved to the planning board. The blueprints are not clear on this point.

We have seen that Lange requires accounting prices to be set by the planning board and not by industrial managers. "All accounting has to be done *as if* prices were independent of the decisions taken." This rule, we remember, is necessitated by the stipulation that industrial managers (who, by definition, enjoy a monopolistic position) must be made to play at competition. This behavior becomes excessively artificial when the industrial managers know full well (and better than the men in the planning board) that present accounting prices are wrong, but when they are nevertheless prevented from instantly making the needed adjustments.

We notice here that this artificial system of pure competition prevents *automatic* adjustments of demand and supply even in the still-existing consumers' goods markets and that it burdens the central authority with problems which it ought to hand over to market forces. Obviously, Lange believes that socialist industrial managers cannot be entrusted with the monopolistic power which their position implies. Anyhow, the system of accounting prices has now been extended even to consumers' goods markets where we thought we could rely on the direct equalization of demand and supply through instant price changes.

The central planning board, having been made responsible for *all* price changes, must adjust prices rather frequently to avoid dangerous discrepancies of demand and supply How long set prices are to remain unchanged we are not told nor are we told how the central planning board will proceed to integrate into a consistent pattern the tremendous number of price changes urged upon it by managers

A particularly important function of the planning board is the allocation of investment funds This allocation will be based upon the rate of interest in comparison with real or anticipated profits The function of the central planning board will consist of weighing expansion claims of different industries against one another Such a survey can be made consistently only in general monetary terms and through a uniform price for the means of expansion—investment funds This price, the rate of interest, must be raised high enough to check sufficiently the total demand for available investment funds

The central planning board cannot prescribe the exact amount of production for each industry, unless we want to assume that the men in the central planning board have the knowledge to predict what, under changing conditions, marginal costs in each industry will be We have to remember that we assumed decentralization precisely because such universal knowledge is not at the disposal of the board Yet many socialist writers emphasize that the central planning board has 'a much wider knowledge of what is going on in the whole economic system than any private entrepreneur can ever have, and, consequently, may be able to reach the right equilibrium prices by a *much shorter* series of successive trials than a competitive market actually does' [26] Dickinson points out that the organs of the collective economy will have incomparably more exact knowledge of one another s actions than enterprises under capitalism since all enterprises work, as it were, within glass walls [27]

This glass wall quality of the liberal socialist economy should not be overstated though it does contain an element of truth Although managers of socialist industries can be better informed than capitalist entrepreneurs, we must remember that there is no need for the capitalist entrepreneur to know more than the prospective demand price for his product and the cost of its production The manager of the socialist industry faces a more formidable task His aim is not the maximization of profit for a firm but the establishment of an equilibrium position for a whole industry He is to act *as if* prices were independent of his actions If he knows that prices are wrongly set and that they must be changed soon, he is told, nevertheless, *not* to make use of his knowledge or his anticipations His wider knowledge does not help him very much in this case The knowledge of the private

[26] Lange and Taylor, *op cit* p 89

[27] Dickinson *op cit* p 213 See also his article "Price Formation in a Socialist Community" *Economic Journal* XLIII (1933), 237 250

entrepreneur may be more limited, but so is his task; and he is permitted to make the most of what knowledge he has and to act promptly.

The glass-wall quality of socialist plants and industries, furthermore, does not eliminate the need for effective decentralization. The superhuman mind which would register and integrate all known facts is not available. The question is not merely how much the industrial managers know; crucial is the ability of the central planning board to integrate into one comprehensive picture the reports, accounts, claims, and counterclaims of industrial managers.

The liberal socialist economy may have many more data in its files than has the capitalist economy; but the planned character of the system, the substitution of official accounting prices for market prices, makes this knowledge imperative. The glass-wall character of the liberal socialist economy, therefore, is not a net advantage; against it must be held the lack of automatic regulation through genuine markets.

The central planning board will provide for the satisfaction of collective wants. It will take care of the public sector of the economy in much the same way that a capitalist government does. We must watch out, however, lest public ownership of the means of production tempt the central planning board into all-too-frequent application of the principles of collective want satisfaction. We know that even in capitalism the public sector has a tendency to grow relatively faster than the private enterprise sector of the economy. A corresponding trend in socialism may be even stronger. As in capitalism, the result could be an authoritarian system.

CHAPTER 17

LIBERAL SOCIALISM'S CLAIMS

Between Capitalism and Central Planning

The trial and-error system which we studied in the preceding chapter is in many respects similar to the capitalist economy "There is," says Lionel Robbins, 'a certain aesthetic attraction in the contemplation of a project which, setting out to eliminate the institutions of a 'planless' society—the 'chaos of competitive enterprise'—arrives finally at an attempt to reproduce them' [1]

The main question seems to be whether under these conditions the change from capitalism to socialism is worth while Is it not a rather roundabout exercise to abolish capitalism through public ownership of the material means of production, to introduce the planned economy, and then to decentralize the planned economy to such an extent that it becomes a mere replica of competitive capitalism? Even Oskar Lange asks, " . but if competition enforces the same rules of allocating resources as would have to be accepted in a rationally conducted socialist economy, what is the use of bothering about socialism? Why change the whole economic system if the same result can be attained within the present system, if only it could be forced to maintain the competitive standard?" [2]

The importance of this question is increased by the possibility, on the one hand, of maintaining a high level of aggregate demand and employment in capitalism, plus the danger, on the other hand, that liberal socialism might develop into an authoritarian system

We must compare liberal socialism with liberal capitalism, i e, with the

[1] Lionel Robbins *The Great Depression* (London Macmillan & Co Ltd, 1935), p 153

[2] Oskar Lange and Fred M Taylor *On the Economic Theory of Socialism* (Minneapolis University of Minnesota Press, 1938), pp. 98 99 Copyright 1938 by the University of Minnesota

system which we can expect to develop if we are willing to do all that is necessary to maintain a high level of productive employment, if we deal prudently with the problems of monopoly, and if we aim at the greatest amount of equality which is feasible in the capitalist economy.

Against this type of capitalism we have to set the advantages promised by liberal socialism. In investigating these promises, we must make sure that liberal socialist assumptions are consistently maintained, that authoritarian solutions are excluded. We shall notice a certain trend toward arbitrary decisions by the central planning board. This is natural, for decentralization and trial-and-error procedure are artificial creations in a system which is basically centralistic. The appeal of authoritarian solutions will be enhanced by the fact that the authoritarian system is more simply structured than a system which indulges in the luxury of broad civil and economic liberties.

The economist has little to say on the political side of the issue. He cannot prove that democratic socialism is utopian, that we are bound for serfdom once we socialize the material means of production. He can show, however, that a trial-and-error system is not clearly distinguishable from a system which is planned by a central authority. We shall see that even socialist writers have expressed doubts that this decentralized solution will be able to withstand the strong trend toward centralist planning which is characteristic of the modern socialist movement.

Income Distribution in Liberal Socialism

In Chapter 5 we discussed income distribution in capitalism. We concluded that the capitalist distribution of wealth and income is quite unequal and that the possibilities for greater equality within the institutional framework of capitalism are limited. Private property in the material means of production, the connection of personal with functional distribution, private capital accumulation, and the importance of the profit motive—all these features make more equal personal distribution difficult and, in some instances, capable of more harm than good. However, in the case where investment opportunities are lacking, we saw that a more equal distribution could actually increase the national income by increasing aggregate expenditure. A more equal income distribution can be achieved by making social services available gratuitously. Among these services free education was seen to be particularly important as a means of reaching a more equal distribution in the future and of increasing the productivity of the economy.

No doubt, liberal socialists can claim that their system will establish a more equal income distribution. This claim is based on the fact that public ownership of the material means of production eliminates the so-called unearned income of private persons. Interest, rent, and profit go to the

government However, we must remember that much of the unearned income in capitalism is either taxed away or saved and invested, it then serves to finance tasks which would likewise have to be financed in socialism This part of the unearned income, therefore, would not be available for distribution to consumers in either capitalism or socialism

As far as wages and salaries are concerned, most modern socialists do not aim at complete and rigid equality It is now generally understood that the maintenance of free choice of occupation implies wage differentials If functional and personal distribution are to be one and the same on the labor market, liberal socialists will have to accept a substantial degree of inequality

H D Dickinson points out that "in a socialist system there is no essential connection between the value of labor and the payment of a sum of money to a laborer " [3] In other words, wages might be used for accounting purposes only, while the national income would actually be divided up according to such principles as perfect equality or payment according to need Dickinson's remark refers, however, to authoritarian rather than to liberal socialism Free choice of occupation makes it imperative that wage differences be used to guide workers into industries where their particular skills can he most productively used Aside from compulsory assignment there exists no method of labor allocation other than the offer of pecuniary or other advantages Compulsory assignment violates the principle of free choice of occupation In liberal socialism wage differences are therefore used for more than accounting purposes, they are essential if lahor is to be allocated without compulsion to the production of commodities which consumers demand

Oskar Lange believes that these wage differentials would be negligible in view of the fact that "the choice of an occupation offering a lower income, but also a smaller disutility, may be interpreted as the purchase of leisure, safety, agreeableness of work, etc , at a price equal to the difference between the money earned in that particular occupation and in others ' [4]

Are income differences in the liberal socialist economy really "only apparent '? [5] In some cases a lower income may be offset by nonpecuniary advantages, such as leisure In many cases, however, jobs which are disagreeable are also badly paid The cause of low wages in spite of great "disutility" is, of course, a relatively large supply of certain kinds of labor, and as far as this large supply is caused by more modest requirements in terms of the laborer's natural endowments, the liberal socialist economy will not be able to equalize incomes, even in the meaning of Lange's broader interpretation

[3] H D Dickinson, *Economics of Socialism* (New York Oxford University Press 1939), p 119

[4] Lange and Taylor, *op cit* pp 101 102

[5] *Ibid* p 102

T. J. B. Hoff has pointed out that Lange is really contradicting himself when "he starts by requiring differentiated income, but arrives at the conclusion that the incomes are in reality the same. . . ." [6]

Of course, in the long run it may be possible to increase the supply of labor in the better-paid fields, once expensive education and training are no longer dependent on private means. We can agree with Dickinson:

> If obstacles to the mobility of labor were removed and if education and vocational training were really free and available to all who cared to take advantage of them, the supply of kinds of labor that are to-day scarce (skilled and professional labor) would probably increase and its economic value fall, so reducing the inequality in personal earnings.

But we can hardly share Dickinson's fantastic conclusion that

> in a socialist community it is possible that the dirty and unpleasant occupations would come to be the best paid, instead of, as at present, the worst; that a cabinet minister or a bank director might elect to serve for a few months as a dustman or a lavatory attendant in order to get enough money for a holiday trip.[7]

Some writers argue that differences in income need not be so great that they correspond to differences in productivity,[8] and they ask why "the game cannot be continued just as well with counters of smaller size—why the difference between an income of $3,000 and $4,000 should not be at least as strong an incentive as the difference between $3,000,000 and $4,000,000." [9]

There seems to be some justification for this argument in view of a great deal of arbitrariness in the determination of very high salaries in capitalism. R. L. Hall may be right in saying that "the experience of companies and of the public service shows us that if the men in responsible positions are getting enough to mark them off from their subordinates, they will feel some duty to perform their functions conscientiously and will find their work interesting for its own sake." [10] We must be careful though. We saw in Chapter 5 that progressive taxation can severely interfere with productivity. Similarly, the allocation of scarce labor skills could be distorted and

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[6] T. J. B. Hoff, *Economic Calculation in the Socialist Society* (London: William Hodge & Company, Ltd., 1949), p. 73.

[7] Dickinson, *op. cit.*, p. 133.

[8] See, for example, J. M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan & Co. Ltd., 1936), p. 374; R. L. Hall, *The Economic System in a Socialist State* (London: Macmillan & Co. Ltd., 1937), pp. 160-161.

[9] Abba P. Lerner, *The Economics of Control* (New York: The Macmillan Company, 1946), p. 42.

[10] Hall, *op. cit.*, p. 161.

their supply reduced if we tried to diminish too much the wage differences which a free labor market tends to bring about

The limitations of progressive taxation will be the same in liberal socialism as in capitalism except that no attention need be paid to the prospect that private capital accumulation will be adversely affected In liberal social ism, as in capitalism, taxation must not eliminate the differentials upon which the working of the price mechanism rests

This statement is equally true for the distribution of a social dividend Lange emphasizes that

> the distribution of the social dividend must be such as not to interfere with the optimum distribution of labor services between the different industries and occupations *The social dividend must be distributed so as to have no influence whatever on the choice of occupation* The social dividend paid to an individual must be entirely independent of his choice of occupation For instance, it can be divided equally per head of population, or distributed according to age or size of family or any other principle which does not affect the choice of occupation [11]

By referring to a social dividend, socialist writers sometimes create the impression that socialist citizens, instead of paying taxes, would receive a share in the government's income However, only the consumed part of unearned income under capitalism is available for distribution, and even this part will be available only if the socialist economy does not aim at a higher rate of accumulation Since the "unearned' income of the government (interest, rent, profit) must finance the public sector of the economy *and* take care of capital accumulation, it is most unlikely that *without taxation* anything would be left for the distribution of a social dividend But if taxes have to be imposed to supplement the government's income from public ownership of the material means of production, the social dividend, as a kind of reverse taxation, becomes a superfluous complication

Bureaucracy and Productivity

In discussing some conflicting opinions about the productivity of liberal socialism, we shall (as in Chapter 6) postpone the consideration of monopoly and unemployment We ask, therefore, how liberal socialism and capitalism would compare if both were working on a sufficiently competitive basis and at high levels of employment Monopoly and employment questions will be taken up presently

Modern socialists have shown greater modesty than have their predeces-

[11] Lange and Taylor, *op cit* pp 83 84

sors in claiming superior productivity for socialism, but they still assert that the socialist economy would be superior to capitalism in productive efficiency.

Some aspects of productivity in socialism were already briefly discussed in Chapter 6. We saw, for instance, that it is impossible to contend that scientific research is dependent on the private enterprise system. World War II and the utilization of atomic energy have inaugurated an era of government research projects which are, in scope, entirely beyond the reach of even the largest private corporation. Since these government projects are feasible within the framework of capitalism, socialism's criticism can be only that not *all* research is carried on in government laboratories. Paul M. Sweezy says,

> Each firm or industry seeks competitive advantage through research and can neither relinquish responsibility to the government nor pool resources with its rivals. Hence it is inevitable that under capitalism work of this kind should be undertaken on a comparatively limited scale and in an uncoordinated fashion. The advantages enjoyed by socialism in this respect are too obvious to require elaboration.[12]

In addition, socialist writers suggest that such scientific results as are forthcoming may be more readily used in socialism than in monopoly capitalism, where new techniques may be suppressed to prevent the depreciation of invested capital.

Critics of socialism, on the other hand, express doubts that socialist managers will make the same prompt use of new methods of production which is characteristic for capitalism under sufficiently competitive conditions.

We know already that the comparison between socialist manager and capitalist entrepreneur does not lead to a clear-cut distinction between bureaucrat and businessman. On the capitalist side of the picture, we must be aware that the private enterprise system is no longer exclusively characterized by the entrepreneur-capitalist who singlehandedly makes all the important decisions, bears the risk, and earns the profit. It is true, that "when ownership and control are united in a single hand there is greater freedom of action, more scope for initiative, a greater readiness to attempt untried ways and to take risks, a quicker response to changing conditions, probably more drive, than are to be found either in joint stock companies or in any socialized industrial form."[13] Under present conditions, however, the comparison must, to some extent, be between the public manager and the manager of the large private corporation. Socialists contend that in this comparison capitalism cannot maintain its claim to higher efficiency.

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[12] Reprinted from *Socialism,* by Paul M. Sweezy, p. 213. Copyright, 1949. Courtesy of McGraw-Hill Book Company, Inc.

[13] A. C. Pigou, *Socialism versus Capitalism* (London: Macmillan & Co. Ltd., 1937), p. 78.

Yet many socialists are, nevertheless, quite conscious of the problem of lacking incentives under bureaucratic management Oskar Lange, for in stance, asserts ' that *the real danger of socialism is that of a bureaucratiza tion of economic life,* and not the impossibility of coping with the problem of allocation of resources " But he makes this concession to the critics of socialism only because he believes that the same, or even greater, danger cannot be averted under monopolistic capitalism 'Officials subject to democratic control seem preferable to private corporation executives who practically are responsible to nobody " [14]

Lange's argument can be accepted where capitalist monopolies are guilty of exploitation, inefficiency, and the obstruction of economic progress Where a sufficient degree of competition exists, however, Lange cannot demonstrate the greater bureaucratic inefficiency which he attributes to capitalism in comparison with socialism True, the capitalist corporation is responsible to nobody except for the fulfillment of contracts freely entered into But in this way it promotes efficiency and initiative rather than bu reaucratic slowness

The essential difference seems to be as follows the capitalist corporation is related to other firms only through the market, it buys and sells accord ing to price-cost relations and not in order to fulfill predetermined quotas, it expands and contracts as profit expectations dictate In all these actions there is no red tape of the kind with which a socialist plant or industry would have to cope The manager of the socialist plant is responsible to the manager of the industry who, in turn, is responsible to the planning authorities *The bureaucratic impediment lies in the external relations of plant or industry and not in their internal structure*

Paul M Sweezy after having stated that ' economic units under socialism will be rationalized versions of the large corporation," goes on to say that "the crucial difference, of course, will be that the objective of the socialist unit will be fulfillment of its share of the general plan, where the objective of the capitalist firm is the maximization of the profit of the corporation.' [15] This crucial difference explains precisely why the socialist unit may suffer much more from bureaucratic restrictions than does its capitalist counter part.

Let us assume that a socialist plant manager has a new scheme to reduce costs The scheme requires the investment of a considerable amount of capital In capitalism the scheme would be introduced without preliminary difficulties and delays if it is expected to be profitable, no bureaucratic decision need be involved In the socialist economy investment funds can be obtained only from the state bank, and the manager does not have an opportunity to prove his new method by experiment till he has convinced the supreme economic council that his way of producing the thing is

[14] Lange and Taylor *op cit* pp 109 110
[15] Sweezy *op cit* p 212

cheaper." Any proposed change must, together with potential changes in other plants, "be examined and approved by the authority, which in this connection will have to take over all the functions of the entrepreneur."[16]

Thus we see that decisions which should rest on intimate knowledge of all existing circumstances are not made by those possessing this knowledge, viz., by the men on the spot, but rather by those in the upper strata of the socialist bureaucracy. The planning authorities, supposedly, act according to advice coming from the producing units, but the higher authorities cannot rely exclusively on the counsel of those whom they are to direct and control. As a rule the requests for additional funds will exceed the available supply, and the competing claims of many industries will thus have to be rated according to their relative merits.

The essence of what we have been saying is that, in a planned economy, individual producing units are no longer integrated by the market, and what is not done by the market has to be done consciously by bureaucratic action.[17]

When Oskar Lange says that the problem of bureaucracy is a more real danger to socialism than is the problem of allocation, he separates problems which are closely related. Bureaucracy may flourish in socialism precisely because real markets no longer exist, because there is a central plan, and because individual producing units must be required to fulfill the figures of the plan. The actions of the socialist manager will not automatically adjust themselves to the requirements of the plan. Managers must be directed and constantly controlled. Free and prompt guidance through prices will be supplanted by bureaucratic guidance via planned quotas and accounting prices, a procedure which may easily be more clumsy than the market. We see that it is the relations among different industries rather than the relations within individual producing units which will be most endangered by bureaucratic arthritis.

True, the liberal socialist wants to use the trial-and-error system in order to avoid too much bureaucracy and to give to consumers and to labor the greatest possible amount of freedom. If the system works, decentralization will avoid some of the pitfalls of bureaucratic planning. If it does not work, if the planned character of the economy must be stressed more and more, then the bureaucratic apparatus must grow; and liberal socialism may change into authoritarian socialism. The problems of bureaucracy and allocation are, therefore, very closely related.

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16 F. A. Hayek, "Socialist Calculation: The Competitive 'Solution'," *Economica*, VII, New Series (May, 1940), 139.

17 Joseph A. Schumpeter, while pointing out that the difference between capitalism and socialism is not a case of irrationality versus rationality, nevertheless felt that "as a matter of blueprint logic it is undeniable that the socialist blueprint is drawn at a higher level of rationality" (*Capitalism, Socialism, and Democracy* [New York: Harper & Brothers, 1942], p. 196). But it seems that Schumpeter rather underestimated socialism's *practical* difficulties.

It has been argued that, as capitalism matures, the state plays a more active part in the economic process but that private corporations frequently consider such action "interference" and thus attempt to render it ineffectual "The result is that there is a tendency for two bureaucracies, each swollen by the necessity of fighting the other, to be built up where one would be sufficient to do all that is required from a strictly economic point of view "[18] A C Pigou, referring particularly to public utilities, suggests that public ownership might be preferable to public control because it would 'obviate expense, overlapping and, above all, friction, if, instead of there being a controlling authority *plus* a controlled one, control and operation were united, as under socialism they would be, in the same hand" That Pigou does not want to create the impression that socialism would be less bureaucratic than capitalism is made clear, however, when he continues '*Pro tanto* this consideration provides a valid argument for extending the range of socialization But that is not the same thing as substituting for the present system general socialism with all-round central planning"[19] Pigou, in other words, refers to what may be called "partial socialization," which does not alter the basic structure of the market economy A publicly owned corporation in capitalism is embedded in the market mechanism The main problems of central planning do not appear It is therefore quite possible that partial socialization will reduce the degree of bureaucratization without proving socialism s superiority in this respect

We saw in Chapter 6 that productivity and profitability tend to coincide when the utility of a product is increased by producing a larger or better product with given means of production, or by adjusting production more readily to the wishes of the consumers We saw that on the other hand, activities which increase the scarcity of products or waste productive resources cannot be called productive, though they may be very profitable

Liberal socialists may well claim that certain cases of profitability which are detrimental to productivity are excluded by the very nature of socialism As Pigou convincingly states,

> A consumers' association for providing itself with raspberry jam will be under no temptation to manufacture pips for it out of wood, a capitalist jammaker may do this A municipal authority will be under no temptation to slaughter animals for food under insanitary conditions to escape the expense of making them sanitary a private butchering concern may do this This is a very important matter, so important, indeed, that in industries closely associated with public health it is customary in this country [England] to insist on rigorous inspection, and, when, as in the construction and operation of sewers, that is, for technical reasons, difficult, on public ownership and operation.

[18] Sweezy *op cit* p 215
[19] Pigou *op cit* pp 45-46

Pigou adds that in such cases of control the degree of freedom of private enterprise is weakened and that the cost of control "ought to be reckoned as a negative element in measurements of its efficiency."[20] In this case, therefore, the cost of bureaucracy has to be charged to the account of capitalism.

The socialist economy can to a large extent avoid the wastes of competition which were indicated in Chapter 6. Milk may then be distributed as we deliver the mail today; one efficient gas station may do the work of three or four competing ones; cutthroat competition among giant firms will be excluded; natural resources will not be wasted by exploitative methods; and excessive advertising may be supplanted by an attempt to educate the consumer. In conceding the last-mentioned advantage we must remember, however, that *authoritarian* socialism may circumvent free consumers' choice by educating consumers to like what the government has produced, even if it be guns instead of butter.

Oskar Lange mentions among the advantages of socialism the comprehensiveness of the items entering into the price system. Following Pigou he shows that

> . . . there is frequently a divergence between the private cost borne by an entrepreneur and the social cost of production. Into the cost account of the private entrepreneur only those items enter for which he has to pay a price, while such items as the maintenance of the unemployed created when he discharges workers, the provision for the victims of occupational diseases and industrial accidents, etc., do not enter, or, as Professor J. M. Clark has shown, are diverted into social overhead costs. On the other side, there are the cases where private producers render services which are not included in the price of the product . . . A socialist economy would be able to put *all* the alternatives into its economic accounting. Thus it would evaluate *all* the services rendered by production and take into the cost accounts *all* the alternatives sacrificed; as a result it would also be able to convert its social overhead costs into prime costs. By so doing it would avoid much of the social waste connected with private enterprise.[21]

Pigou suggests that, theoretically, "these maladjustments are capable, under capitalism, of being set right by an appropriately devised system of bounties and duties" though the difficulties in practice would be quite formidable.[22]

> How for example, are we to ascertain to what extent the social cost, as measured in money, of the marginal unit of beer exceeds the private

[20] Pigou, *op. cit.*, pp. 90, 91.
[21] Lange and Taylor, *op. cit.*, pp. 103-104.
[22] Pigou, *op. cit.*, p. 42; see also his *The Economics of Welfare*, 4th ed. (London: Macmillan & Co. Ltd., 1938), pp. 192-193.

cost by making necessary the provision of extra policemen, how are we to make the corresponding calculation for a factory industry the smoke of which increases the expenses of the public in washing and cleaning? How, *per contra*, are we to reckon up the indirect benefits that the planting of a forest may have on climate? [23]

In referring to these statements, Lange forgot to tell the reader that Pigou is of the opinion that "a central planning authority would find it no more easy than the government of a capitalist State to obtain the data required for these calculations" [24]

Liberal Socialism and Monopoly

In discussing the problem of monopoly within the framework of a liberal socialist system we must remember that socialist industrial managers enjoy a *de facto* monopoly, that a real, competitive market economy does not exist that for this very reason a trial and-error system with accounting prices has to be introduced, and that pure and perfect competition are replaced by rules of behavior for managers

The following remarks are not meant as an attempt to deny the disadvantages of private monopoly, which have already been enumerated in Chapter 7 If however, these disadvantages are to be used as a justification for liberal socialism, two questions must be asked We must find out, first, whether there are no solutions other than full-fledged socialism, and we must make sure, next that liberal socialism will eliminate the dangers of monopoly On both counts the answers are not as obvious as some writers think

If an industry is in a position to exploit the consumer, or if the competitive struggle is excessive, such an industry can be nationalized, particularly if nationalization would be more efficient and less bureaucratic than mere public control The history of capitalist countries offers examples of this type of partial socialization As we have seen, partial socialization is basically different from total socialization, which alone would establish a socialist economy It must be clearly understood that nationalization of single industries does not create the allocation problem typical of the socialist economy The pricing process of capitalism is kept intact at the same time that the problem of monopolistic exploitation is solved Either monopolistic prices are reduced so that they just cover the cost of production, or the profit goes to the government

The second question—whether the dangers of monopolistic abuses are eliminated in liberal socialism—is more difficult to answer Undoubtedly, there will be no *private* monopoly in socialism But we must remember that the socialist economic unit is the industry rather than the plant, and that

[23] Pigou *Socialism versus Capitalism*, p 43
[24] *Ibid*, pp 43-44

there is therefore only one seller of each product. Even the consumers' goods market is characterized by the monopolistic position of the government, just as the labor market finds the government in a monopsonistic position. It can be argued, of course, that government agencics will not try to exploit the citizens as consumers or workers. It is possible, however, that industrial managers might make use of their *de facto* monopolistic (or monopsonistic) position. They might, for instance, charge higher-than-cost prices in order to accumulate capital. To avoid the derangement caused by innovation, which might be rather formidable in a bureaucratic system, a manager may be satisfied to leave conditions as they are, being able to do so because he is not exposed to real competition in his field.

Although liberal socialist managers are supposed to "play at competition," they may not play the game conscientiously, because they can simplify their problems by using their sheltered monopolistic position. For this reason, the auditing apparatus of the ccntral planning board must act as an efficient umpire in the game. Since the relevant technical knowledge rests with the industrial managers, it will be difficult for the auditors to tell the men on the spot what they ought to have done. Socialist managers may bc mainly interested in avoiding personal risks. Although they may not use their monopolistic powers for the purpose of exploitation, the results for the economy might be similar to those of monopolistic restrictions in capitalism. While socialist misuse of monopoly power might be less dramatic, it could be more widespread and insidious.

Liberal Socialism and Full Employment

Mass unemployment was shown to be the greatest evil that can befall the capitalist economy (Chapter 8). It was also pointed out (in Chapter 9), however, that there are methods by which aggregate expenditure in the capitalist economy can be controlled to maintain a reasonably high level of employment and at the same time retain the essentially private enterprise character of the capitalist system.

Socialists criticize the unplanned character of capitalism. We are told that since consumption, production, saving, and investment rest on innumerable independent and individual decisions, it is not at all surprising that mass unemployment occurs frequently. The planned economy would much better coordinate the actions of the various producing units, prevent discrepancies between saving and investment, and make full use of available resources.

In these assumptions the socialists are basically correct. Not that occasional overproduction in socialist investment goods industries would be impossible. Most likely, substantial mistakes would be made. But the socialist economy will be able to localize overproduction and avoid a general deflationary trend. "Concretely: a crisis centering in the cotton industry

may in the capitalist order put a stop to residential construction, in the socialist order it may of course also happen that the production of cotton goods has to be drastically curtailed at short notice, though it is not so likely to happen, but this would be a reason to speed up residential con struction instead of stopping it."[25]

We might well ask, therefore, whether such an important aim as full employment does not justify changing from capitalism to socialism Again, however, we must make sure that the evil of capitalist unemployment is so incurable that the whole system must be scrapped, that capitalism can not be saved by the policies discussed in Chapter 9 Then, too, we must consider the price we may have to pay for full employment under socialism

Full employment is not identical with the most economical use of the available resources Full employment through make work rules or labor camps would not necessarily be preferable to open unemployment Even if all who want to work are "gainfully" employed, the national income is not always greater than if the same economy were exposed to mild cyclical fluctuations Dynamic growth cannot always be perfectly steady It is possible that the liberal socialist regime might maintain its favorable employ ment level through avoiding disturbing changes which, in the long run, would prove to be productive This danger has already been suggested in the discussion of the monopolistic and bureaucratic character of socialist production

In addition, we must remember that the liberal socialist economy shares with capitalism the difficulties which result from free choice of con sumption If individual freedoms are the cause of disturbances, liberal socialism may be tempted to use the simplified formula of authoritarian socialism For the same reason, however, capitalism may be in equal danger of resorting to fascist solutions Both liberal systems may yield to authoritarian temptations, neither can claim complete immunity

Socialism would also be exposed to some of the difficulties which full employment creates in capitalism If, with Lord Beveridge, we define full employment as 'having always more vacant jobs than unemployed men," this means that the labor market would be a seller's market with labor in a favorable bargaining position Lord Beveridge lists among the difficulties of a liberal, rather than authoritarian, solution of the unemployment problem the fact that labor's bargaining strength may lead to a vicious spiral of inflation[26]

If this inflationary development is "repressed' by price control and ra tioning, it may easily have detrimental effects on the efficiency of labor Where higher wages cannot buy more, or can buy more only at exorbitant black market prices, efficiency will decline

[25] Schumpeter, *op cit* p 195
[26] William H Beveridge, *Full Employment in a Free Society* (New York W W Norton and Company, Inc 1945) pp 18 22 199

Even in normal times, without repressed inflation, full employment can be detrimental to labor discipline and efficiency. Paul M. Sweezy believes that the abolition of unemployment in socialism "may, especially in the early stages of socialist development, seriously complicate the problem of maintaining labor discipline." He believes that socialism "will have to develop a code of labor law which ensures the maintenance of labor discipline, in much the same way that capitalism has evolved a code of commercial law which ensures the maintenance of discipline in such matters as payment of debts, fulfillment of contracts, and the like." [27]

How Much Planning?

When liberal socialists claim superiority for their order over capitalism, they do so on the assumption that their's is a centrally planned system, whereas the capitalist process is blind, haphazard, and chaotic. Yet liberal socialists waver in their emphasis on central planning. Sometimes we gain the impression that the planners, with a wealth of knowledge at their disposal, can integrate different production processes by a shorter series of trials and errors; and sometimes we are impressed by the suggestion of grand development schemes which make us temporarily forget that the consumer was to guide production. At other times, however, the consumer seems to be in full command; and the central planning board, after having set rules of behavior for socialist managers, seems to limit itself to making price adjustments and decisions about capital accumulation.

To authoritarian economists this last case appears to be a rather defeatist attitude and a very anemic kind of plan. Indeed, this emasculated form of socialism is so disappointing to most socialists that the liberal socialist blueprint is most unlikely to be followed in practice.[28] According to Sweezy,

> Lange's Board is not a *planning* agency at all but rather a *price-fixing* agency; in his model production decisions are left to a myriad of essentially independent units, just as they are under capitalism. Such a system is certainly conceivable, but most socialists will probably feel that it reproduces some of the worst features of capitalism and fails to take advantage of the constructive possibilities of economic planning.[29]

The weak as well as ambiguous nature of liberal socialist planning is indicated by Dickinson's attitude. Although Dickinson's *Economics of Socialism* is a book of 237 pages, only on pages 219 to 225 do we find a discussion of planning, and this discussion begins apologetically as follows:

> So far, the reader will say, there has been little talk of planned economy. The S.E.C. [Supreme Economic Council] has been described as

[27] Sweezy, *op. cit.*, pp. 205-206.
[28] Dickinson, *op. cit.*, p. 17; Paul M. Sweezy, *op. cit.*, p. 233.
[29] *Ibid.*, p. 233.

a mere statistical board, collecting and publishing data of output, cost, price, capital and income, calculating demand and supply schedules, but not exciting any real directive functions All that has been done is to set up within the socialist community a sort of simulacrum of a capitalist economy, purged from the latter's grosser errors, but, like it actuated by the blind choice of millions of unco-ordinated consumers and producers This is now the place to make clear the proper relation of economic planning to the price-process The two are not opposed but complementary, principles of economic regulation [30]

According to Dickinson, planning in liberal socialism is only marginal It supports the pricing system and does so in four different ways "The first is to give general directives to socialist economy The second is to make decisions where market indications are lacking The third is to eliminate cyclical fluctuations in economic activity The fourth is to deal with special emergenc es " [31]

General directives according to Dickinson, will be necessary when the government has to rebuild the economic life of society out of the ruins left by revolution and civil war In this stage "the first thing to do would be to ensure a supply of bare necessities to the people without any consideration of the rights of property and without much consideration for the niceties of an elaborate system of pricing and costing " Later on, however, as a more normal level of productivity is again reached, "the great majority of lines of production would be carried on automatically within the frame work of costs and prices so as to supply goods to consumers according to their preferences as indicated in the market " Dickinson believes that finally 'a stage would be reached in which the economic machine would practically run itself The planning authority would need only to lay down a few very general leading principles, and to make definite decisions re garding the allotment of resources to new capital construction and to communal consumption ' [32]

Since governments of modern capitalist countries are committed to maintain high employment levels and to act in emergencies, it is doubtful whether Dickinson has enlarged our concept of planning beyond that which is either equally possible under capitalism or clearly implied in the very definition of liberal socialism But the weak nature of their central plan ning deprives liberal socialists of some claims they have made Indeed, liberal socialism and liberal capitalism could be so similar that the change to socialism might hardly be worth while, particularly in view of the still unsolved problems of factor allocation and bureaucratic management in dicated above

[30] Dickinson *op cit* pp 219 220
[31] *Ibid* p 220
[32] *Ibid* pp 223, 222

PART FIVE

THE ECONOMICS OF CENTRAL PLANNING

CHAPTER 18

Authoritarian Socialism and Central Planning

CHAPTER 19

The Command Economy of Soviet Russia

CHAPTER 20

Authoritarian Capitalism: Germany 1933-1945

CHAPTER 18

AUTHORITARIAN SOCIALISM AND CENTRAL PLANNING

Introduction

In discussing capitalism and liberal socialism we assumed consumers' sovereignty. In both systems the production process is consumer-oriented and not harnessed into the shafts of a predetermined central plan. To follow the wishes of consumers means to allow continuous changes in the allocation of productive resources; to follow a central plan means prearranged production.

But it could be argued that central planning of investment can be made compatible with consumers' sovereignty. Could not consumers' preferences, as they express themselves in demand prices, be made to guide the plan? To be sure, the planned supply may prove to be too large or too small *ex post,* i.e., when compared with actual demand on a price-cost basis. But the same is true in a market economy, whether capitalist or liberal socialist, on occasions when the anticipations of entrepreneurs or managers turn out to have been wrong. The required corrections could be made in the planned economy in the same way they are made in the market economy.

To this argument we may add that many investment processes are so far removed from the final consumers' goods (and have to be planned so far ahead of consumer demand) that changes in consumer demand (unless they are fluctuations in the size of aggregate demand) need not become a very disturbing element in investment planning. Not all demand for investment goods is a derived demand. Even in capitalism there is much "autonomous" investment, which is made possible by innovation and is carried through in the hope that future consumption will justify the outlay.

Thus it is not entirely impossible to imagine a combination of planning and consumers' sovereignty. It is even easier to combine free choice of oc-

cupation and central planning A rigidly predetermined central plan might not seem to leave much leeway for choice on the part of the working population We shall see, however, that compromise solutions are possible in which centrally planned systems use free occupational choices, and corresponding wage differentials, to increase labor's efficiency That difficulties will arise from this combination of freedom and planning is obvious, but these difficulties can be overcome to some degree

These introductory remarks are intended to show that the division between free and centrally planned systems need not be as absolute as it may appear in the present chapter Nevertheless, it seems justified to discuss central planning first under the assumption that those who are in charge set the aims of production and are not willing to have their plans disturbed by market price changes which emanate from free consumers' choices Central planning approaches the problems of the social economy, as it were, from the opposite end The road does not lead from consumers' choices via market prices, to production processes guided by these prices, rather, it leads from planned aims, via *ex ante* integration of the factors of production to results which consumers have to accept

These two approaches are not clear-cut opposites, but it is both best and realistic first to discuss them as such This discussion will show that efficient central planning cannot dispense with the aid of pricing, just as free systems will not be willing to forego all the advantages of planning

Part V consists of three chapters The present chapter considers the economic problems of authoritarian socialist planning It grows logically out of the discusion of liberal socialism and contains the authoritarian answer to liberal socialism Chapter 19 tries to use a few experiences of Russian central planning to illustrate several practical issues This chapter is not in any way meant to be a comprehensive description of the planning process in Soviet Russia, but it will add realism to a discussion which need no longer remain entirely in the realm of pure theory Chapter 20 tries to use examples of central planning in an authoritarian capitalist system These illustrations are taken from the German economy under Hitler It will be interesting to note the similarities and dissimilarities between central planning under, first, socialist and, then, capitalist authoritarianism

With a knowledge of both the market type economies and the centrally planned systems, we shall then be able to discuss several problems which arise when the two approaches intermix and overlap This task will be undertaken in Part VI

Central versus Marginal Planning

We have seen that the liberal socialists' attitude toward central planning is not shared by authoritarian socialists Paul M Sweezy, for instance, does

not like this milquetoast version of planning. He believes that a socialist economy will need real central planning rather than a mere price-fixing agency. He starts from the investment problem, not from consumers' preferences, and consistently arrives at the conclusion that planning must become all-inclusive.

> In an unplanned economy—whether capitalist or collectivist—investment decisions are made by many independent units. . . . It is this circumstance that accounts for the irrational behavior of an unplanned economy: the alternation of booms and slumps, the coexistence of gluts and shortages, the paradox of unemployed workers with unsatisfied wants. . . . It is scarcely conceivable that the socialist state will so decentralize the making of investment decisions as to recreate the blindness and uncertainty of unplanned capitalism. Moreover, it is not hard to see that the centralization of investment decisions makes comprehensive economic planning all but inevitable. Assume, for example, that the government of a socialist society makes a basic policy decision to invest a certain percentage of the national income over a period of, say, five or ten years and lays down certain general goals such as the building up of heavy industry, the rehousing of a specified proportion of the population, and the development of hitherto backward regions. The next step would naturally be to charge the Central Planning Board with the task of drawing up an investment plan for carrying out these decisions. This investment plan will begin by translating the general goals laid down by the government into quantitative terms: so many new factories, railroads, power plants, mines, apartment houses, schools, hospitals, theaters, and so forth. The dates at which these various construction projects are to be started and finished will then be specified. From these data it will be possible to draw up schedules of the different kinds of materials and labor which will be required. At this point the investment plan may be said to be complete. But would it be sensible for the Central Planning Board to stop here and to rely on price and income controls to ensure that what is needed will be ready at the right time, at the right place, and in the right quantities? The answer is surely that it would not be.

After the requirements of investment are taken into account

> . . . the Central Planning Board will find it necessary to estimate consumer demand for all products which compete for resources with the investment plan and to draw up a second set of schedules showing the different kinds of materials and labor which will be required. It should now be possible, by consolidating the investment and consumption schedules and by comparing them with current and prospective sup-

plies, to work out a general plan for the development of the economy over the period in question When a consistent and practical plan has finally been adopted, it cannot be left to the discretion of individual industry and plant managers whether or not they will conform to it, rather it must be their first duty, imposed by law, to carry out their part of the plan to the best of their ability—just as, for example, it is the duty of corporate managers under capitalism to make profits for the owners [1]

Here, finally, we have the real picture of a centrally planned economy—where the price system no longer encompasses the plan, where consumers no longer decide what is to be produced, where managers no longer act independently on the basis of price-cost relations The central planning board does not rely on prices to ensure that what is needed will be ready "at the right time, at the right place, and in the right quantities " The plan controls everything, and the price system, if used at all, becomes entirely subservient to the plan

That we have moved away from the liberal socialist models of Lange and Dickinson is admitted by Sweezy, who regards it "as established by both theoretical reasoning and practical experience that a socialist economy will be centrally planned in a sense very different from that in which Lange's model may be said to be centrally planned " [2]

In moving away from the trial and error model Sweezy feels obliged to ask whether rational accounting and allocation, which are possible in Lange's model, are also possible in a comprehensively planned economy "Is it possible,' he writes, "that in going from one to the other we have unwittingly fallen into the clutches of Mises and his followers?' Of course, he is of the opinion that this not the case,

> that rational accounting and allocation are still possible under comprehensive planning As the experience of the Soviet Union proves, there is no conflict between comprehensive planning and money calculation The crucial difference between Lange's model and the comprehensively planned economy lies in the location of the authority to make decisions about production In the one these decisions are made by many independent units, in the other by the Central Planning Board This shift in the location of the authority to make production decisions in no way disturbs the logic of Lange's argument [3]

Why, however, did Sweezy not tell his readers that Lange believes the trial and-error method to be just as applicable to authoritarian as to liberal

[1] Reprinted from *Socialism*, by Paul M Sweezy, pp 234 236 Copyright, 1949 Courtesy of McGraw Hill Book Company, Inc

[2] *Ibid* p 238

[3] *Ibid* pp 238 239

socialism? Probably Sweezy wanted to detract his readers from Lange's description of a comprehensively planned system. Lange feels that such a system must clearly be an authoritarian one

> . . . where freedom of choice in consumption and freedom of choice of occupation are non-existent and where the allocation of resources, instead of being directed by the preferences of consumers, is directed by the aims and valuations of the bureaucracy in charge of the administration of the economic system. In such a system the Central Planning Board decides which commodities are to be produced and in what quantities, the consumers' goods produced being distributed to the citizens by rationing and the various occupations being filled by assignment. In such a system also rational accounting is possible, only that the accounting reflects the preferences of the bureaucrats in the Central Planning Board, instead of those of the consumers.[4]

Lange rejects this system because of its undemocratic character and its "incompatibility with the ideals of the socialist movement." [5]

Lange also discusses a compromise between central planning and free choice of consumption. He suggests that free choice of consumption need not imply that production is actually guided by the preferences of consumers:

> One may well imagine a system in which production and the allocation of resources are guided by a preference scale fixed by the Central Planning Board while the price system is used to distribute the consumers' goods produced. In such a system there is freedom of choice in consumption, but the consumers have no influence whatever on the decisions of the managers of production and of the productive resources. There would be two sets of prices of consumers' goods. One would be the market prices at which the goods are sold to the consumers; the other, the accounting prices derived from the preference scale fixed by the Central Planning Board. The latter set of prices would be those on the basis of which the managers of production would make their decisions.[6]

Lange does not believe that such a system would be tolerated by the citizens of a socialist community.

In Sweezy's description of central planning, investment decisions are made by the central planning board according to its preference scale. The

[4] Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism* (Minneapolis: University of Minnesota Press, 1938), pp. 90-91. Copyright 1938 by the University of Minnesota.

[5] *Ibid.*, p. 95.

[6] *Ibid.*, p. 96.

board must see that the different industries produce whatever the plan demands This can conceivably be done by making limited use of the pricing process, i e, by allowing industrial managers to bid against one another on factor markets The central planning board must then see that more important industries are equipped with correspondingly more purchasing power than are less important ones To avoid price inflation aggregate purchasing power would have to be limited and increased allocations to industry *A* would have to be made at the expense of reduced allocations to *B* or *C*

Sweezy, however, does not seem inclined to leave the operation of the plan to the pricing process Allocations are *physical* allocations and production targets are targets *in kind* Accounting prices, credits and monetary transfers may be used but the importance of these financial phenomena must not be exaggerated Money can still perform the function of a unit of account particularly where aggregates of dissimilar things are in need of a uniform means of expression The use of money, furthermore, offers an excellent opportunity for keeping check on the fulfillment of the plan All transactions between producing units must be paid for by checks drawn on accounts in the state bank The sums must correspond to the number of physical units delivered multiplied by their accounting prices Finally, there may be real markets for consumers' goods and for labor, and the planning board must see that the total supply of consumers' goods times their prices equals the total purchasing power of consumers

While these functions of money and of money prices in the centrally planned economy are important, they are not *guiding* functions Major decisions and allocations are made irrespective of these prices We must try to find out, however, whether prices are still used for consistent cost accounting

The Premises of Authoritarian Planning

The theory of authoritarian planning has found its most advanced expression in the writings of Maurice Dobb We shall follow Dobb in our theoretical discussion of authoritarian socialism, just as we followed Lange in studying the liberal socialist blueprint [7]

We are interested only in questions concerning the authoritarian socialist *economy* The political power behind the decisions of the central planning board is not the subject matter of our study This power could conceivably be in the hands of a group of experts chosen by democratic methods [8] We

[7] Maurice Dobb *Soviet Economic Development since 1917* (New York International Publishers 1948)

[8] See e g Barbara Wootton *Plan or No Plan* (London Victor Gollancz, Ltd 1934) p 311 Joseph A Schumpeter *Capitalism Socialism and Democracy* (New York Harper & Brothers 1942) pp 296 302

call the economic system authoritarian when consumers' sovereignty is abolished.

Maurice Dobb's theory of central planning rests on the following premises:

(1) The importance of free choice of consumption has been greatly overstressed by bourgeois and socialist writers. Consumers' goods may be distributed through the market, but production need not be directed by the consumer. Consumers' sovereignty can and should be abolished.

(2) The choice among different production patterns is far less formidable than it is made to appear in bourgeois literature. The question is not how to find an optimum combination of factors among an *infinite* variety of possible combinations. Historical, technological, and social conditions limit the practical choices of the central planning board to manageable proportions.

(3) The longer the contemplated planning period, the greater is the number of possible investment patterns. Such long-run plans cannot be made by *independent* producing units, because they rest on parallel developments of *interdependent* industries.

(4) Economic development through long-run planning is more important than the question of how a perfect static equilibrium can be achieved.

(5) Equilibrium in the development process can be maintained through so-called "balances" by which the internal consistency of the plan is constantly checked.

(6) Through these balances the interrelationships of the different industries are known and planned *ex ante*, in contrast to the tardy capitalist way of *post facto* coordination through the price mechanism. However, the plan has to be constantly reshaped as it is carried out. Only in this sense may it be said that a trial-and-error procedure is used and that decentralization is important.

The Abolition of Consumers' Sovereignty

Socialist writers have often pointed out that free choice of consumption has little meaning in the capitalist economy (a) because of the inequality of income distribution, which leads to "plural voting,"[9] and (b) because in any complex economic system the choice lies with producers rather than with the consumers.[10]

The first point is well chosen. But even authoritarian socialism cannot claim perfect equality of income distribution as long as free choice of occupation is maintained. Abba P. Lerner, furthermore, is quite right when

[9] See, e.g., Maurice Dobb, "Economic Theory and the Problem of a Socialist Economy." *Economic Journal,* XLIII (December, 1933), 588-598.
[10] Wootton, *op. cit.*, p. 173.

be points out that the authoritarian socialist's "urgency for exact equality of voting goes ill with the bureaucratic contempt for the intelligence of the voter "[11] Equal voting rights would be important if consumers were to guide production But this function is to be taken over by the central planning board of the authoritarian socialist economy

The second point argues that consumers never direct production anyhow, that they merely choose among goods *which are already there* We have seen that, owing to the law of large numbers, the producer can foresee the wants of a multitude with more ease and accuracy than a consumer can foresee his own wants[12] We are not to understand, however, that production for the market eliminates the consumer as final arbiter Barbara Wootton, after emphasizing that the initiative must always lie with the producer, admits that in the unplanned economy it is impossible "to go on persevering with a wrong guess, pretending that it is right." In the planned economy, on the other hand, "there is no such definite limit, since mistakes can be covered up by subsidizing one article out of the profits of another, or manipulating the purchasing power of consumers, or by similar devices which are open only to those who control virtually the whole economic life of the community, and not merely certain industries "[13]

Dobb argues correctly that "with regard to new commodities and varieties of a commodity catering for new wants, in no economic system can the market afford any automatic index to guide production "[14] Nevertheless, he seems to forget that it does make a lot of difference whether the producer must be anxious to please the consumer and to anticipate his wishes or whether a central planning board decides arbitrarily on the variety and quantities of the commodities to be produced

Dobb believes that the number of different commodities whose production must be considered is fairly small "The items which compose consumers' aggregate demand to any large extent form a closely interrelated set bound together, e g by social convention or by links of complementarity between particular wants into 'modes of life' or patterns of behavior which assume the character of organic wholes " In addition, we must produce commodities on a sufficiently large scale, and this reduces drastically "the number of different things that it is practicable to put simultaneously into production "[15]

Both arguments are rationalizations of the natural tendency of the authoritarian economy to bring about a much higher degree of standardization of individual behavior and of production While this makes the authoritar-

[11] A P Lerner "Economic Theory and the Socialist Economy," *Review of Economic Studies* II (1934 1935), 51-61

[12] See Chapter 3, p 25

[13] Wootton, *op cit*, p 173

[14] Dobb, *Soviet Economic Development*, p 377.

[15] *Ibid.*, p 5

ian economy less complex—and conceivably more productive in physical units—it tends to make it less productive in terms of satisfaction of human wants. Those who believe in consumers' sovereignty suggest that we leave it to consumers to decide what price they are willing to pay for diversity in want satisfaction. They also believe, with J. M. Keynes, that the loss of personal choice "is the greatest of all losses of the homogeneous or totalitarian state." [16]

It is true that for a country which is still poor the problem of choice is not a very difficult one; the planners could rather easily decide what the bare necessities of life are. But "as primary wants are satisfied and variety is multiplied, the alternatives become more numerous and choice between them more controversial and less calculable." Dobb believes, however, that by that time "the difference to be made to human welfare by the difference betwen two alternative solutions of the puzzle will have become a quantity of a relatively small order." [17] This is exactly what the advocate of consumers' *sovereignty denies. He wants his solution and not the solution of* the central planning board.

Dobb points out that

> the nearer that a society approaches to an equality of income-distribution, the more likely it is that market-demand for a very wide range of articles will be characterized by this sort of discontinuity: above a certain price the article (let us suppose it is some new commodity like bicycles, wrist-watches, radio sets or refrigerators) will have scarcely any purchasers at all, because few or none can afford it; while immediately below this price the demand for it may become almost infinitely elastic because everyone will now wish to acquire it, until the supply has become adequate for all, when the demand may once more become quite inelastic.[18]

Although a more equal income distribution will help standardize demand, we must remember that there will be considerable income inequality in an authoritarian socialist economy which wants to preserve free choice of occupation. This income inequality, together with the fact that even persons with relatively equal incomes have widely varying tastes, will necessitate the production of a wide range of goods and services. It remains to be seen whether the authoritarian economy could substantially reduce the number of different commodities which it must produce unless it used its dictatorial powers for that very purpose.

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[16] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan & Company, Ltd., 1936), p. 380.
[17] Dobb, *Soviet Economic Development,* pp. 19-20.
[18] *Ibid.*, pp. 20-21.

The Choice of Production Patterns

Dobb believes that the task of the central planning board is far less formidable than some economists seem tn think. The board does not have to choose 'among an indefinitely large number of economic patterns'' [19] The choice is rather narrowly limited, at least in the short run, by the following facts

(1) Productive resources cannnt be shifted at will, they are not very tractable

(2) Technical consideratinns impose a minimum scale of production for many products

(3) At any given time the productive resources are woven into a given pattern whicb cannot be changed suddenly nr without considerable cost

(4) Technical coefficients of production require production processes tn be internally consistent and forbid the cnmbination of factors unless all required elements are available in the right quantities

(5) Expansion of production *A* without contraction of production *B* depends on the existence nf reserve productive capacity

(6) The pattern of productinn is partly determined hy the pattern of consumption discussed above

None of these points, except the last one, indicates that the variety nf production processes would be more limited because of the nature nf the authoritarian socialist economy *unless the central planning board wished thus to simplify its task arbitrarily* Of course, some pattern of production is given at any moment of time But a great number of changes can be hrought about within a sbort time Many factors can be put to different uses This does not mean that we have constantly to choose anew from among an infinite variety of possibilities Any social economy, whether capitalist, liberal socialist, or authnritarian, will rest for most of its daily decisions on the past pattern It will try to use only loose strands to weave tbe altered design necessitated by changes in preferences (consumers' or the planning board's), techniques, or factor supply The technological coefficients are nbviously the same in any modern social system of equal technical maturity Since, therefore, the advanced authoritarian socialist economy would tecbnically resemble the advanced capitalist ecoomy, the task faced by its planning board would be a rather difficult ooe, even in the short run

Long-Run Planning

The strongest argument for central planning is that independent producing units cannot plan far ahead becanse they are not able to predict the actioos

[19] *Ibid*, p 3

of others with sufficient accuracy. Modern industrial production is a complicated and intricate process in which every single industry rests on instruments and materials made by other industries, just as its own products can be sold only if other industries or the consumers are in need of them. The individual producer can anticipate the actions of others merely for the near future and, even then, only with some degree of uncertainty. Then he must wait and see whether subsequent price developments justify his actions; whereupon he may proceed another step.

The planned economy depends, as we saw, on the same technical interrelation as does the unplanned economy. But we are told that it would make *conscious* use of the knowledge of this relation and would

> substitute *ex ante* co-ordination of the constituent elements in a scheme of development for the tardy *post facto* co-ordinating tendencies that are operated by the mechanism of price movements on a market in a capitalist world—tendencies, moreover, which in the presence of substantial time-lags may merely achieve extensive fluctuations. In this the essential difference between a planned economy and an unplanned evidently consists.[20]

Dobb points out that such *ex ante* coordination, by eliminating much uncertainty, not only permits a given objective to be attained more smoothly but also makes possible developments which the capitalist economy cannot undertake because the independent producer cannot be certain "that others will follow suit and take parallel action which coordinates with, and justifies, his own." [21]

Dobb emphasizes the importance of planned development in contradistinction to the achievement of perfect equilibrium at any given point of time. Bourgeois and liberal socialist theory are, according to him, preoccupied with equilibrium analysis. They want to find "an *optimum* allocation of resources between alternative uses, with both resources and uses treated as given." [22] He suggests that "a more crucial test of the contribution made by an economic system to human welfare" is to be found in the system's ability to develop successfully from one situation to another. And in this respect he believes the centrally planned economy to be far superior to the unplanned economy.[23]

But the theory of central planning cannot dispense with the concept of economic equilibrium. Any social economy must try to reach a position in which all currently available productive resources are fully employed and in which they are distributed among different industries in such a manner

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[20] *Ibid.*, p. 9.
[21] *Ibid.*
[22] *Ibid.*, pp. 2-3.
[23] *Ibid.*, p. 3.

that all production processes gear into one another All industries in need of a particular factor of production must get a sufficient amount of it to enable them to fulfill their production quotas, and all intermediate industries must produce enough to enable others to reach their targets Because all industries are interrelated in the most intricate manner, the centrally planned economy must see that they cooperate smoothly and avoid bottlenecks or unemployment—danger signals that disproportions may have developed in the economic process Bottlenecks appear where what is needed is not ready at the right time, at the right place, or in sufficient amounts Bottlenecks, in turn, prevent the use of complementary means of production, thus, unemployment appears, and leads to underfulfillment of plan figures and to new bottlenecks in an ever-widening circle

The necessary coordination of the means of production can be achieved by use of so-called "balances," i e, "a complex system of equations between the various magnitudes in a plan as the tests of internal consistency or coherence between its various elements" [24] These balances can be "real," "material," or "physical" balances For example, all quantities of a given material used in all production and consuming units during a given period of time can be added, and this sum can then be compared with the forthcoming supply of the material or with the total of each of the various factors of production needed to produce the given material in such quantities

The production plan of the authoritarian socialist economy is "a complex of output-programmes for all the main products of the economic system, embracing real expenditure and real product, input and output in each case" [25] Not all the balances in this production plan can be real or physical balances Where dissimilar things are to be added together, we need equations or balances in monetary terms Monetary balances are necessary, furthermore, where money incomes are earned and spent on consumers' goods and where wage differentials are used to regulate the supply of labor for different industries

When we introduce factor and product prices, we change "real" balances into monetary balances and the production plan into a financial plan Producing units must be supplied with enough purchasing power to be able to buy necessary means of production The quantities of the various factors needed in different production processes are indicated by technological coefficients and plan quotas These quantities have to be multiplied by factor prices to determine the "planned cost" of production "Planned profit" may be added, and greater-than-average economy in the use of factors may lead to higher than planned profits This extra margin may possibly be used as "collective incentive" [26]

[24] *Ibid*, p 331
[25] *Ibid*, p 348
[26] *Ibid*, p 355

Once a producing unit is supplied with the necessary working capital, it should be able to maintain its liquidity through the sale of its product. Obviously, the state bank, which carries the accounts of all producing units, can trace all their receipts and disbursements, and check whether funds were spent in accordance with the aims of the plan. The operations of the state bank, therefore, will serve as a comprehensive auditing apparatus.

Central Authority and Industrial Management

Obviously, the central planning board cannot make all the detailed decisions which are necessary to implement a comprehensive plan. Needed technical knowledge rests with industrial and plant managers. Only the men on the spot, furthermore, can adapt the plan to unforeseen changes. It must be expected that *ex ante* coordination cannot work to perfection and that there will be deviations from plan figures. Such discrepancies must be detected and corrected at the earliest possible moment, i.e., before they have cumulative effects. This work cannot be done by the planning board alone.

How, then, does authoritarian socialism propose to combine central decisions and the actions of local managers in such a way that specialized knowledge and initiative are used to the best advantage and that the whole system maintains a sufficient degree of elasticity?

A central plan, based on *ex ante* coordination, cannot permit managers to act independently. It is essential, however, that managers participate in the earliest stages of the central plan's formulation. Although policy decisions, of course, are made in the highest echelons, the detailed factual knowledge (without which policy decisions must remain rather vague) must come from the managers. Only they know the technological data and the available resources. As Dobb says, "policy determines to what ends the resources available are put; but the means available always in some measure condition the ends that it is possible at any given time to choose." [27]

The plan, as initially sketched by the board according to very general directives from the highest authorities, will undoubtedly contain many mistakes and inconsistencies. Only the men nearer the periphery will be able to correct it. The plan will be perfected through practical experience. The target figures will have to be handed down by the board to the industrial and geographical units and will be handed back with many corrections and suggestions. Then the board will draw up an improved plan, whose figures will again be handed down to the different producing units—until the "balances" balance. This succession of approximations resembles the way equilibrium is approached in a price system; it can be said that the plan grows to perfection in a series of trials and errors during which disproportions

[27] *Ibid.*, p. 335.

contained in general policy decisions are eliminated by expert knowledge. But this trial-and-error process is not identical with the pricing process in either capitalism or liberal socialism. The corrections to be made concern only inconsistencies in the planned coordination of the various industries. Production managers in industry *A* will point out, for instance, that it is *technically* impossible to reach the plan figures unless 20 per cent more of a given material is allocated, that the time schedule cannot be met, that transportation facilities are inadequate, or that more skilled labor is needed. These criticisms do not overrule the central decision but only act to modify it to the degree necessary to make the various output programs compatible.

Compare this rather modest function with the task of the quasi-independent manager in the liberal socialist blueprint. He has no predetermined plan figures to meet. He watches factor and product prices and is free to produce more or less as prices command and as he is successful in procuring needed investment funds. The output of consumers' and producers' goods is not prearranged through *ex ante* coordination; rather, consumers are free to change their demand, and production is supposed to adjust itself to these changes. Production is guided by prices, and these prices are expressly protected against arbitrary manipulation.

In the authoritarian socialist economy the function of prices is reduced to the more modest task of supporting the planning process. Prices may have to be changed if it turns out that the financial balances do not balance. That the price of a product exceeds its planned cost is quite natural and does not necessarily lead to changes in production. Suppose that consumers, free to spend their wages, would like to buy many more pairs of shoes at cost price than the authorities care to have produced. The equilibrium price of shoes will then be much higher than the planned cost *without leading to increased production of shoes.* In the trial-and-error method of the liberal socialist blueprint the production of shoes would have to be stepped up until the difference between price and cost is eliminated.

We need not discuss the difficulties inherent in the bureaucratic setup of the authoritarian socialist order. These difficulties have been enumerated for liberal socialism in Chapter 17, and, if anything, they will be greater in authoritarian socialism. This is because liberal socialism favors the trial-and-error method expressly to eliminate excessive bureaucratism. Authoritarian socialism will have to develop administrative methods which seek the loyal and intelligent cooperation of the managers in both drawing-up and executing the plan. These methods must leave scope for initiative and still harness the producing unit "firmly within the shafts of the Plan." Dobb believes that "with both its output and the sale-price of that output fixed in advance by the Plan, the enterprise can do nothing to improve its financial position by restricting output: on the contrary, to restrict output will reduce its receipts and hence any profit left in its hands." [23]

[23] *Ibid.*, p. 355.

The Basic Problem of Central Planning

The crucial difference between liberal and authoritarian socialist economies is the abolition of consumers' sovereignty in the latter, and the replacement of the pricing process, or at least most of it, by *ex ante* coordination. The elimination of consumers' sovereignty makes it necessary to decide whose preferences are to take the place of consumers' preferences. How are the basic policy decisions to be made? How will it be determined how much steel, how many tractors, and how many miles of road are to be produced?

As yet we have learned little about the process by which these decisions are arrived at. Taking the abolition of consumers' sovereignty for granted, can we still arrive at a combination of aims which is clearly preferable, from an economic point of view, to other combinations?

Let us leave out of account statistical methods by which consumers' wishes might be ascertained. These methods would be clumsy compared with the pricing process on the consumers' goods market. More interesting is the suggestion that we make use of the services of experts, that medical doctors draw up a comprehensive health service, that teachers redesign our educational system, and that physicists and generals control the output of atomic energy. Obviously the authorities must secure the opinions of experts in setting aims for the economy; just as they need the help of managers in formulating and executing the plan. But this reference to expert opinion leaves the main problem still unsolved, for "someone must coordinate the experts." [29]

The claims of different groups of experts would surely overtax the available resources. If this is so, according to which principles are we to decide how much weight is to be given to the different programs which compete for our limited resources?

We have already seen that even a dictator would be constrained by the fact that available resources and present production patterns limit the output of investment and consumption goods. Even if the central planners were willing, however, largely to continue the existing pattern of production, realism would require that they still exercise a great deal of choice, especially in the long run. Indeed, without this choice there could be no *ex ante* planning. "Planning" would be reduced to "the extrapolation of observed trends of past years into the future," [30] and this would be much too timid an interpretation of central planning. Planning as an extrapolation of past trends would merely "freeze" past patterns of production

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[29] H. D. Dickinson, *Economics of Socialism* (New York: Oxford University Press, 1939), p. 48.
[30] Dobb, *Soviet Economic Development*, p. 325.

which should *at least* adjust to changes in such exogenous data as changes in techniques and in factor supplies[31]

The constraining influence of factor supply and technical know how is extremely important Dobb believes that these limitations facilitate the task of the central planning board because they narrow to manageable proportions the practical choice open to the authorities At the same time, these very limitations increase the importance of making correct choices The more limited the resources, the less we can afford waste, and the more complex the industrial pattern, the more difficult *ex ante* coordination becomes

Concerning the basic policy decisions which are to shape the structure of the plan, we have no way of showing that one combination of aims is better than another In authoritarian socialism we must accept the preference scale of the authorities, just as we accepted consumers' sovereignty in the market economy Once the aims are set, the authorities assign to the central planning board the task of determining the pattern of production (or, more correctly, the changes in the existing pattern) which promises to fulfill these aims All industries and plants must fulfill predetermined targets, and, since all production processes are interrelated, the planning of the whole economy is a formidable task

In the formulation of the most basic decisions (rapid industrialization, emphasis on long-range missiles, relocation of industry, etc) a comprehensive pricing system could be very useful if it were permitted to operate as an accounting aid It would not affect o basic decision, such as emphasis on armaments, but it would help determine opportunity costs Even the authorities of the centrally planned economy must think in terms of "alternatives sacrificed" if they want to act rationally, and the intent to act rationally is implicit in the concept of planning Opportunity cost calculations, however, are not very practical in terms of physical units If we do not have a common denominator, we could never decide whether 10 units of factor *a* plus 20 units of factor *b* plus 5 units of factor *c* cost more or less than 8 units of factor *a* plus 12 units of factor *d* plus 7 units of factor *x*

Once the general aims of the authoritarian economy have been established, the planning agencies have the task of translating these aims into concrete production programs The minimum requirement is technical integration, i e , the production processes must be made to gear into each other without too much waste or friction A trial-and error procedure can bring about this industrial coordination However, the rationale of the plan requires more than this Indeed, all means of production should be subject to uniform and consistent pricing throughout the economy, so that the

[31] Much of the interference by authorities in market economies amounts, indeed, to a freezing of the status quo Import quotas and exchange controls, with allocations according to the situation which existed in a base year, are good examples

marginal productivity of the various factors would be the same in all industries.

It seems that Dobb assumes the existence of prices when he stipulates that "data are available about the comparative productivities of different investment-projects and about their construction costs." In this case "a basis will exist for calculating the *net productivity* of each project." He defines net productivity as "the output (valued at current prices) from the plant over a given period *less* the prime cost of producing that output, expressed as a ratio to the construction cost of the plant, again calculated in terms of current cost in wages and materials involved in construction." [32]

Dobb makes these suggestions to show that it is not necessary to use some kind of interest rate expressing the scarcity of total capital resources. Actually, he seems to come quite close to just such a calculation.

Let us assume that a manager must make a choice between either more or less capital-intensive production processes. In most plants and industries this problem will arise. If the choice is to be made at zero rates of interest, *the desire for capital intensity will become so overwhelming that even* engineers, responsible for the selection of the production methods, would become suspicious of the technological utopia implied. In the discussion of the Russian planned economy we shall see how managers had to use (as a substitute for interest rates) some formula which related reductions in future operating costs to marginal additions to fixed capital.

But it is not enough that each individual industry should use its own formula. The distribution investment funds among different industries, too, ought to rest on uniform application of the same formula throughout the economy. If the authoritarian policy makers attempt to solve their problems purposely without the use of interest rates, they reduce the efficiency of their system. The reason can be only prejudice and lack of understanding, for the economical allocation of resources would in no way interfere with the authorities' supreme freedom of choice. A rate of interest would make it easier to choose rationally (because of the clearer expression of opportunity costs), would aid proper translation of the authorities' aims into production plans, and would facilitate selection of the proper capital intensity for the different production processes. Since the choice between Sputniks and opera performances would not be affected, the authoritarian regime could, in terms of its own logic, only gain and not lose.

We can now summarize the most characteristic features of authoritarian central planning as follows:

(1) The most basic decisions concerning the aims of the plan are not made on the basis of price-cost relations. They are essentially political decisions. This does not mean, however, that costs are not considered at all. Limited resources make it necessary to choose in terms of opportunity costs.

[32] Dobb, *Soviet Economic Development*, p. 14.

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(2) The aims of the authorities must be translated into production programs which properly integrate all production processes in all industries This is not exclusively an engineering task At zero rates of interest the demand for capital goods would reach absurd dimensions A rate of interest (or some substitute for such a rate) must be used to help determine the proper capital intensity of each industry in the economy Factor and product prices, too, must be uniform

(3) Only on the basis of a uniform cost analysis can the proper choices be made and the aims of the plan be reached in the most economical way Or, to put it differently, only careful use of factors according to their relative scarcities will permit the achievement of maximum productivity

(4) Consistency in the setting of aims, in the translation of these aims into production programs, and in factor allocation must all rest on a monetary or financial basis Consistent calculation in physical units is not practical

(5) A trial-and-error method will be used in the sense that a well-integrated production process can only be worked out in successive stages Every major change in aims, in technology, or in factor supply will necessitate new trial-and error adjustments

(6) A major problem of the authoritarian socialist economy concerns the relation between the central authorities and the peripheral managers Of course, the managers are narrowly confined by the plan, but it is understood that the expert knowledge of the men on the spot is indispensable for both the preparation and execution of the plan

CHAPTER 19

THE COMMAND ECONOMY OF SOVIET RUSSIA

Introduction

In studying the blueprints for a liberal socialist economy we had to limit ourselves to theoretical considerations because a practical application of these blueprints has, as yet, not been tried.[1] In the case of authoritarian socialism we are more fortunate, since we can now look back on over forty years of Russian experimentation.

Central planning has worked in Russia, though not too well, as we shall see. Anyhow, Mises' dire predictions were proven wrong. We recall that Mises believed that a social economy could not function without private ownership of the means of production, real markets, and genuine market prices.[2] The Soviet economy, however, was able to prove that, by trial and error, a modicum of technical integration of the various production processes could be evolved. Today we must admit that a centrally planned economy does not have to "flounder without a compass in the ocean of possible and conceivable economic calculations." The authoritarian socialist system can force the whole population into hard work and frugal consumption and thereby achieve a very high rate of investment; through trial and error it can achieve an *ex post* correction of the *ex ante* integration of its investment programs; and it can undertake long-run development schemes which transcend the possibilities of a private enterprise economy.

Although Mises was too extreme, Soviet central planning is not beyond criticism, and the most fundamental economic criticism is precisely that Russian central planning does not make use of a consistent economic ac-

[1] Later we shall see that recent Polish and Yugoslav developments cannot be interpreted as a change from authoritarian to liberal socialism.
[2] See Chapter 14, pp. 162-163.

counting process. The authoritarian socialist economy has not been shipwrecked but its course has not been as straight nor has its journey been as fast as it might have been.

This criticism would be valid even if we otherwise wholeheartedly agreed with the authoritarian system, i.e., if we were willing to subscribe to the aims which are set by those in power. If, however, we insist on consumers' sovereignty, we must then criticize authoritarian socialism not only for its lack of a consistent process of factor allocation but also for the supreme contempt which it has shown for the wishes of present consumers. In part, this latter issue is of a political philosophical nature and, accordingly, outside the area of our investigation. It is probable, however, that central economic planning requires an amount of simplification which would make consumers' sovereignty impractical even if it were politically acceptable.

The Russian Road to Central Planning

The development of central planning in Russia has been the very opposite of a controlled experiment. There were several special circumstances, it must be remembered, under which this first test of comprehensive central planning was undertaken.

In 1917 the Russian economy was predominantly agrarian. It had not reached that final stage of capitalist development which, according to Marx, is the precondition of a successful economic revolution. As a matter of fact, the Russian revolution must have come as a shock to orthodox Marxists, who had to see it as a flagrant violation of Marxist dogma. The Bolshevists explained their heretical behavior by pointing out that their revolution was meant to be part of a world wide chain of revolutions and that its prematurity of a few years would thus be insignificant in historical perspective. Had the other revolutions materialized, the one sidedly agrarian character of the Russian economy would allegedly not have mattered too much.

In addition to being based on an agrarian economy, the introduction of socialism in Russia started with the distribution of large landed estates among many thousands of small peasants—again the opposite of what one would have expected of a Marxist experiment, for comprehensive central planning was thereby made impossible. Private land ownership implied market transactions between agriculture and industry. Only after the second agrarian revolution, i.e., after the collectivization of farms more than ten years later, was it possible to force this important sector of the economy into the plan; only then could the plan begin to be comprehensive.

The first experiment in central planning under modern conditions had to be started without the benefit of any previous thinking about the way such an enormous task could best be undertaken. Lenin was conscious of the fact that Bolshevist textbooks did not contain a blueprint of central

planning and that trial-and-error procedures had to make use of existing capitalist facilities under the control of the government. But an orderly experiment in state capitalism, in which the state would hold the "commanding heights," proved impossible. In industry, direct action by the proletariat threatened to lead to a deterioration of the socialist experiment into syndicalism. (This, the most naive and primitive of socialist movements, provides that workers take over their respective industries but gives no thought whatever to the essence of central planning—the effective integration of the different industries and firms.) In agriculture, the liquidation of landed estates was followed by a drastic reduction in the amount of agricultural products available to industry (particularly since industry did not produce enough consumers' goods for purpose of market exchanges).

The outbreak of civil war hastened the general economic breakdown. Production declined disastrously, and the government had to turn to the printing press when regular revenues practically disappeared. Hyperinflation, finally, destroyed completely the cooperation between the industrial and agricultural sectors on which everything depended.

The failures of this first period were taken by the outside world as proof that socialism was impossible. We know now that these conclusions were premature. The circumstances had been too unfavorable: a peasantry with no incentive to produce the vitally needed agricultural surplus; an industry without experienced managers; an undisciplined, syndicalist, and badly fed labor force; an inexperienced bureaucracy; a market system without commodities to trade; a breakdown of the price system without the substitution of a central plan; and an environment of political turmoil. The early Soviet "system" was neither a market economy nor a planned economy; it was not an experiment in socialism but a struggle to survive under the impact of revolution and civil war.

When we look back upon this period between 1917 and 1921, generally referred to as the period of War Communism, we can understand why it must have frustrated those who wanted a centrally planned economy but were, as yet, unable to force the elusive peasant element to produce the needed surplus of food and raw materials. The desire must have been strong to find some way of collectivizing agriculture as the precondition of comprehensive *ex ante* planning.

But the time had not yet come. Central planning could not arise out of chaos. Instead, the government had to turn in 1921 to the forces of the market and to monetary incentives. Peasants were permitted to sell their surplus on the market after a fixed proportion of their crop had been paid to the government in kind. This arrangement implied the possibility of buying industrial products. Accordingly, industrial managers were permitted to sell their products on markets and to buy needed materials rather than to wait for bureaucratic allocations. Industrial producing units, though state-owned, were to be managed on "commercial principles."

However, this so-called New Economic Policy was meant to be a temporary expedient only, a transitional stage between a capitalist market economy and a future central plan Productivity had to be revived to the point where collectivization and mechanization of agriculture could be undertaken and the preconditions for central planning fulfilled Throughout this period the state occupied the "commanding heights" Controlling heavy industry, the credit system, transportation, and international trade, Soviet leaders could feel reasonably sure that the market forces which they had let loose would be kept within bounds

The New Economic Policy, with its dependence on markets and commercial principles, needed a stable monetary unit for its calculations and transactions Those who had greeted the repudiation of money with enthusiasm had learned a lesson It was now admitted that the Russian economy would remain a monetary economy for the foreseeable future Money remained important after most of the expedients of the New Economic Policy had become history

The Escape from "Genetic" Planning

The New Economic Policy did no more than restore prewar productivity, and even this moderate success was achieved only because the NEP relied on market forces and catered to some extent to the wishes of peasants and workers It is interesting to notice that during this period profit rates and wages were higher in light than in heavy industry

These conditions were not permitted to continue Industrialization was considered essential for several reasons World revolution had not materialized Soviet Russia, 'encircled' by capitalist nations, felt that she neither could nor should depend on these nations to supply her with capital goods Furthermore, only on the basis of a greatly expanded heavy industry could the agricultural sector be mechanized to enable it to produce the food and materials which the industrial sector required To these reasons we can add that central planners are obsessed by an urge to industrialize—an outgrowth of the grandiose development schemes and also, perhaps, the result of a feeling that authoritarian socialism finds firmer support among industrial workers than among peasants

To have satisfied the successful farmer (kulak) by producing more consumers' goods would have retarded the speed of industrial development in favor of the most "capitalist" element of the population At the same time, it was doubtful whether even better "terms of trade" for the farmer would have achieved the desired increase in agricultural output, owing to the distribution of land among small holders Stalin certainly doubted it He said,

> The way out is to turn the small and scattered peasant farms into large united farms based on the common cultivation of the soil, to introduce

> collective cultivation of the soil on the basis of new and higher technique. The way out is to unite the small and dwarf peasant farms gradually and surely, not by pressure but by example and persuasion, into large farms based on common, co-operative cultivation of the soil, with the use of agricultural machines and tractors and scientific methods of intensive agriculture. There is no other way out.[3]

We see from this quotation how large-scale farming on cooperative lines appeared as "the only release from that closed circle of interdependent limiting factors"[4] within which the discussion of recent years had revolved. The question had been whether "genetic" or "teleological" planning should be used. The genetic method amounted, in the main, to an extrapolation of the development of the different branches of the economy during the last few years. When we remember that agricultural production was still outside the plan, we can see that the planned economy was limited by the rather unpredictable actions and reactions of a huge private sector. Furthermore, the elicitation of greater efforts in agriculture would have required concessions in the form of increased production of nonagricultural consumers' goods—the very opposite of the planners' aims.

The teleological school refused to be made dependent on the unplanned sector. Dobb has pointed out that once

> the transformation of peasant agriculture on to an entirely new basis had been placed on the agenda, and had justified its claim to be regarded as a practicable solution, the situation was radically changed. A new qualitative element had been introduced, providing a break in the closed circle and altering the pattern of "causal-genetic" determination. There was now no more reason to assert the one-way dependence of industrial growth on the growth of agriculture than to assert the contrary (for example, the dependence of agricultural production on the supply of tractors and of chemical manures).[5]

In other words, real planning would become possible as soon as the government had succeeded in drawing agricultural production into the plan, rather than letting it remain an uncontrollable limiting factor.

From these Soviet experiences we can conclude that authoritarian central planning cannot tolerate the existence of a really free market sector, that it must by necessity become total planning. Liberal socialism may settle for genetic planning, but only if it is willing to do without the type of *ex ante* planning which forced the Soviets to "find a way out."

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[3] Quoted in Maurice Dobb, *Soviet Economic Development since 1917* (New York: International Publishers, 1948), p. 222.

[4] *Ibid.*

[5] *Ibid.*, p. 330.

The Collectivization of Agriculture

Agriculture was collectivized (in 1930 1931) by draconic measures,[6] but the peasants who were forced into collectives were permitted to retain their dwellings with some adjoining land, farm implements, dairy cattle for personal use, etc Thus an attempt was made to solve the economic and sociological problems of the agricultural sector through a combination of large-scale production methods and subsidiary farming From the standpoint of the planner this was a compromise solution, untidy and only temporary It repeated within the collective farm the conflict which had characterized the Russian agricultural problem on the national level, viz, how to have central planning and yet induce the individual peasant to produce Having retained part of their farms, the members of the collectives were (and still are) tempted to devote more time to subsidiary farming than the planners wished

The collective farms were both mechanized and drawn into the plan by use of "machine tractor stations" As well as providing technical services to the farms, these tractor stations were also administrative organs which insisted on plan fulfillment They incidentally—but importantly—facilitated governmental procurement of farm products, for they were paid in kind for their services

The equipment of the machine tractor stations has now been bought by the collective farms The main reason for this recent change seems to have been the desire to avoid divided responsibility and administrative waste Because the collectives have been encouraged to merge into supercollectives, and because the local party apparatus has become strong enough to assume the controlling functions of machine tractor stations, the latter could be eliminated It has been suggested that the collectives can now be made to assume a greater share in the expense of agricultural mechanization It is hoped that, having been provided with this investment outlet by the government, they will become less eager to exchange their earnings for consumers' goods[7]

The abolition of the machine tractor stations cannot be interpreted as a step toward de-collectivization On the contrary, the trend is toward bigger collectives and huge state-owned farms and toward a gradual abolition of subsidiary farming Important is the change in the government's price policy, i e, the increase in farm prices together with a reduction of the prices of industrial consumers' goods—a concession which is intended to

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[6] Cf Stalin s remarks to Churchill on the "terrible struggle" of collectivization in Winston S Churchill, *The Hinge of Fate* (Boston Houghton Mifflin Company, 1950), pp 498-499

[7] See Lazar Volin Soviet Agriculture under Khrushchev,' *American Economic Review*, XLIX (May 1959), 19 21

increase agricultural productivity and to prevent a mass migration from agriculture.

The shortcomings of central planning, which will be discussed presently, express themselves in the agricultural sector in an imbalance of mechanization and in the mixture of "dwarfism" and "giantism"[8] which has been indicated. While giant producing units will facilitate central control, it seems doubtful that this violation of the law of decreasing returns will help increase productivity.

The Russian Command Economy

The Russian economy, as it emerged after the collectivization of agriculture, does not correspond to the extreme form of authoritarian socialism which was the subject of Mises' criticism. Limiting ourselves to the barest outlines, and ignoring the kaleidoscopic changes which have occurred in the administrative structure, we can draw the following generalized picture.

The Soviet government either owns outright, or controls decisively, all material means of production. This is now essentially true for agriculture as well as for industry. Production therefore follows the command from above and is carried through in fulfillment of plan figures, not in reaction to price incentives. Russian managers, in other words, do not follow commercial considerations, as under the New Economic Policy. The Russian economy is a command economy, not a market economy.

Consumers are normally free to purchase in government stores without ration coupons. It must be emphasized, however, that free consumers' choice is limited to the commodities which the government decides to produce. The government may let its decision be guided to some extent by what it believes the consumers' wishes to be, but consumers' sovereignty does not exist in the sense that "the consumer is always right." Consumers do not direct production as in capitalism or, supposedly, in liberal socialism.

Nevertheless, free choice of consumption is of importance in the Russian economy for the following reason. The Soviet government permits, on the whole, free choice of occupation. With many exceptions, labor is free to move. The allocation of labor rests, in the main, on wage differentials. These must be so adjusted that they attract to each occupation and industry the amount of labor required to fulfill output quotas. Wage differentials imply free choice of consumption. Too many restrictions on consumption would tend to blunt the monetary incentive of higher wages.

Within the framework of its all-inclusive plan, the government must take care of education and training. This obligation provides an opportunity to steer the flow of those newly entering the labor market to occupations and industries favored by the development plan. To this lever we must add

[8] *Ibid.*, pp. 16-17, 26.

many cases of exhortation, of limitation of mobility, and of outright coercion These exceptions to the principle of free choice of occupation enable the government to allocate contingents of labor when wage differentials prove to be insufficient

The Soviet government determines the rate of accumulation, i e , it decides how total production is to be divided between consumers' goods and investment goods The totalitarian socialist system has several ways to keep consumption below the national product level

(1) The prices of consumers' goods are set substantially higher than production costs Most of the difference constitutes a turnover tax The amount of the tax for individual commodities depends on the supply of the commodity in comparison with demand, because commodity prices are normally set to equalize demand with a predetermined supply The Soviet government could, of course, adopt a policy by which it would expand and contract production of different consumers' goods until the margin between cost and price (i e , the turnover tax) would be the same percentage amount for each commodity But we have seen that the Soviet government is not interested to any extent in consumer preferences and does not want to complicate the operation of the plan

(2) The government determines the total wage bill and can thus maintain a given level of wages in relation to a given higher level of prices But the planners obviously find that wage increases are a highly useful part of their incentive system They thus may prefer the necessary limitation of consumption to be achieved more indirectly, i e , through higher consumers' goods prices

(3) As any other government, the Soviet government has the power to create new money These additional funds can be added to the investment total

(4) The Soviet government borrows from the people (to reduce the purchasing power of consumers) against the promise of future payments, e g , of lottery gains

(5) The procurement of the agricultural surplus can take the form of state purchases of prescribed quantities at prices below cost—a counterpart to the "overpricing" of consumers' goods via the turnover tax

How are Soviet investment funds used? This is the most crucial question which the system of *ex ante* planning has to answer To understand and to criticize the Russian solution, we have first to see how the planning procedure operates

Soviet Planning

We have seen that the Russian economy is a command economy The government's command regulates the interdependent actions of producing units

on the basis of one comprehensive plan. Predetermined production quotas and appropriate allocations, rather than competitive buying and selling, are the characteristic feature of this new method of integrating the production process.

The aims of the economy are decided upon by the highest party authorities and not by the consumer. The central plan translates these aims into production targets for the different industries, plants, and collectives and sees that the branches of the economy keep in balance with one another.

Authoritarian central planning means more than the setting of broad development schemes and production targets; it means the careful quantitative and qualitative enumeration of thousands of items which are needed in the life of a nation, from rolling mills to hairpins, from atomic energy to school equipment and ballet performances. This task is so formidable that it cannot be solved by the central planning agency alone. "It is impracticable for the central authorities to prescribe physically every product and input, or to prescribe some of them—indeed usually most of them—in completely disaggregated terms." [9] To illustrate by a much ridiculed example from the Polish economy: the plan should not endeavor to name the number of sour pickles or of hares to be shot.[10]

The aims of the plan are competitive. Each production target must be limited so that the total of all targets does not exceed the productive power of the nation. And since the factors of production are substitutable only within limits, the production program must be drawn up with reference to the given technical possibilities. Each industry's output depends on an input of intermediary goods which are the output of other industries. How can the plan relate all input and output figures and achieve the coordination of production processes which results in the output of all needed goods in the right proportions?

But even this formulation of the problem is incomplete. The gradual achievement of a workable technical interdependence is not sufficient if we want to make the best economic use of the factors of production. Technological interdependence guarantees that the system will function without breakdowns resulting from the development of bottlenecks; however, it does not guarantee the best combination of factors in an economic sense. To achieve the most economical production, quantities and techniques ought to be so chosen that the marginal productivity of each factor is the same wherever used.

The problem would be greatly simplified if for each production process only one technique were available. Actually, however, there is nearly always a choice between different degrees of capital intensity. We remember

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[9] Gregory Grossman, "Industrial Prices in the USSR," *American Economic Review*, XLIX (May, 1959), 59.

[10] Alexander Erlich, "The Polish Economy after October, 1956: Background and Outlook," *American Economic Review*, XLIX (May, 1959), 96.

that not only has the social economy to solve the problem of *what* and *how much* to produce, it must also answer the question *how* to produce, i e , which technique to use

Through much trial and error the Soviet system has achieved a modicum of technical consistency But it remains, at least officially, unconscious of *the waste which is implied in its emphasis on technology*

This criticism cannot be answered by reference to the fact that Soviet production does not follow the wishes of the consumer, it remains true with respect to any set of preferences No system can solve its economic problems by recourse to technology But an autocratic system can pretend, of course, that what it produces is exactly what it wants It may even pride itself in the fact that only the most modern techniques are used though this statement, of course, is never true for all production processes simultaneously

Leaving aside all bureaucratic details, we can draw the following *simplified* outline of Russian planning methods

First, the authorities decide on such basic issues as heavy versus light industries, location of industries, the development of atomic energy, etc

With these general directives and the existing production pattern to work with, experts will draw up a tentative plan which translates, as far as feasible, the general development aims into concrete production targets *The interrelation of all production processes makes it imperative* that these production targets pass the test of mutual consistency However, this *interrelating* of production targets consists mainly in revising and adjusting an already existing production pattern which, in turn, was the result of many previous adjustments

The planners cannot know all the technical details and cannot give commands in completely disaggregative terms concerning product mix, input mix, the capital intensity of production methods, etc This kind of specialized knowledge rests with operational managers These men must be consulted While they will have no right whatever to question the aims of the plan, they must cooperate in the setting of input and output figures for their industries and plants Otherwise, they would be placed in the impossible position of having to achieve results which cannot be achieved on the basis of planned allocations

Tentative plan figures are, therefore, distributed through the administrative channels of the Soviet bureaucracy down to industrial and agricultural producing units These figures are not yet directives, rather, they are requests for corrections Corrections and suggestions are then collected through the administrative arteries of the system

Based on this material, a new plan is drawn up, and this plan, once adopted, becomes the official production program Its detailed production figures become compulsory *instructions* They are commands

Of course, the final figures which result from this planning procedure

cannot possibly be perfect, not even in the limited sense of technical consistency. They rest on assumptions which cannot always be correct. The weather or the terms of foreign trade cannot be ascertained in advance, just as the rise in efficiency per man-hour may elude exact quantitative estimates. For these and other reasons (e.g., human failure) it is vitally important that the execution of the plan be watched constantly so that imbalances can be corrected at the earliest possible time.

It would be wrong, however, to overestimate the difficulties which the planned economy faces in achieving balance in the limited sense of technical consistency. No social-economic system is perfect in this respect, including certainly the capitalist economy with its overinvestment crises, which are nothing but huge disproportions in the development of different branches of the economy. We have to remember, furthermore, that it is possible to create flexibility through the accumulation of reserve stocks, i.e., inventories which make the supply of strategic materials temporarily independent of current production. Finally, figures given for long periods (five years and more) are never more than broad targets or even "ranges." Operational plans are formulated for much shorter periods, and the commands refer to minima for output and maxima for input rather than to rigidly fixed amounts.

Prices in the Soviet Economy

From the economic standpoint planning authorities should allocate available resources according to (1) the relative importance of different products in the authorities' scale of preferences, (2) the technological coefficients of production, and (3) the relative scarcity of the factors of production.

This calls for the use of a uniform, comprehensive, and consistent system of accounting in which (1) uniform prices are charged for units of identical factors, (2) factor prices change with changes in the relative scarcities of the factors, and (3) changing factor prices lead to new allocations even though the aims of production remain the same as before.

While we assume the scale of preferences to be given, we ought to remember that a change in this scale would automatically alter the relative scarcities of the factors. In a rationally planned system, moreover, the aims must to some extent depend on the relative scarcities of the resources, as expressed by factor prices.

The Soviet economy does not correspond to this picture. The aims of the plan are not set after a careful consideration of opportunity costs. The Soviet system does not have prices which reflect the relative scarcities of factors. In particular, it does not use a rate of interest in allocating its investment funds. Since factor allocation is not based on a consistent accounting process, it deteriorates into an attempt to secure technical consistency

with the help of physical and financial balances Theoretically, this process could dispense with prices altogether if all physical details could be minutely prescribed and if adherence to plan commands could be adequately checked Practically, this is not possible, such prescriptions and controls would overtax the ability of the planners

Though it has been decided to dispense with economic accounting at the planning stage, the Soviet system cannot dispense with monetary or financial balances on the operational level This is true for the following reasons

(1) The operational units must be controlled for plan fulfillment Since these units buy one another's products at "transfer" prices and in prescribed quantities, the state bank, on which all checks are drawn, can serve as an auditing agency

(2) Wages are paid in money and are spent on consumers' goods in government stores The Soviet government must see that total wage income plus transfer payments and the total value of consumers' goods are equal if inflation is to be avoided

(3) The problem of securing the most economical factor allocation, which the planners can ignore, cannot be ignored on the operational level Industry and plant managers must decide how to make the most economical use of the funds which are available to them for investment purposes They must make a choice between production methods of different capital intensity If this choice were made at zero rates of interest, the suggested solution would be so capital intensive as to be absurd Soviet engineers have found it necessary "to develop various theories to justify the use of capital charges and to explain their nature" [11] They have done this in spite of the fact that this is heretical behavior in the light of Marxist doctrine Increments of proposed capital expenditure are in practice compared with the savings in future operating costs which such investment is expected to permit No use is made, however, of such terms as "interest" or 'capitalization"

Of course, these theories and practices should not be confined to the operational level where they can be applied only in a compartmentalized fashion In the planning stage it would be even more important to compare initial outlay with future operating costs for *all* branches of the economy which compete for investment funds Otherwise there cannot be a consistent allocation of the factors in relation to the scale of preferences

Why, then, do the planners refuse to establish a generalized system for the allocation of investment funds? The answer must be sought in their adherence to Marxist dogma and in their refusal to adopt devices which appear to be borrowed from the textbooks of liberal socialism or even capitalism Another reason is that the practical introduction of such a

[11] Gregory Grossman "Scarce Capital and Soviet Doctrine," *Quarterly Journal of Economics* LXVII (August, 1953), 317

general system may logically lead to a degree of decentralization which authoritarian socialism is unwilling to permit.

As matters stand, prices in the Soviet economy have no guiding function. Only when this point is kept clearly in mind will we be able to appreciate a price "system" (to say nothing of "mechanism") which maintains two—and often widely diverging—prices for each commodity. "Transfer" prices are those at which goods exchange among producing units, while "index" prices are used for aggregating purposes.[12] Were index prices used for allocation purposes, they would do more harm than good. Perhaps they were set years ago and, even then, incorrectly. But even if correctly set they would soon have lost validity.[13] Nor could transfer prices be relied upon. They are a controlling and auditing device and do not have the function of equating demand and supply. Equilibrium is achieved through command and in physical terms. Were transfer prices entrusted with establishing a market balance, the result would be highly inflationary in the producer goods sector (similar to the removal of price controls in a market economy *before* an existing excess of purchasing power had been mopped up). An entirely different price structure would have to develop if a real price mechanism were to replace physical commands and allocations.

The Problem of Decentralization: Poland and Yugoslavia

Soviet ideology rejects the proposal that the central plan be replaced by decentralized cooperation among more or less autonomous production units.[14] But in post-Stalin Poland and Yugoslavia, reforms have been proposed and carried through which aim at a substantial degree of decentralization. Though these reforms are still too recent to offer sufficient evidence, they do at least indicate trends which are interesting for the student of the Soviet system. They stem from criticisms which are similar to those indicated above.

The opposition to the Russian type of central planning in Poland rested on the following considerations.

(1) If the task of central planning is to amount to more than a mere dovetailing of technological requirements, if it is to include the substitution of relatively plentiful for scarce factors, it is a task which is too big to be

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12 Grossman, "Industrial Prices in the USSR," pp. 53-54.

13 The fundamental price reform of 1949, e.g., changed a price structure which was based on the prices of 1926-1927, i.e., on prices established during the period of the New Economic Policy. See M. C. Kaser, "Soviet Planning and the Price Mechanism," *Economic Journal,* LX (March, 1950), 81-91.

14 The decentralization in post-Stalin Russia has nothing to do with our present problem since it concerned only a territorial rearrangement in planning procedures. Cf. Oleg Hoeffding, "The Soviet Industrial Reorganization of 1957," *American Economic Review,* XLIX (May, 1959), 65-77.

properly undertaken by the central planning agency alone Decentralization is essential

(2) Even the lesser aim of achieving technical consistency has not been reached Disproportions have arisen and interrupted the production process, owing to insufficient supplies, power failures, etc [15]

(3) The price structure is entirely wrong In the absence of completely rigid physical allocations (i e, considering the minimum of freedom which must be allowed on the operational level) wrong prices result in wrong guidance of production "Where managers had any leeway in combining their inputs or in altering their output-mix, irrational prices have induced them to deviate from the plans imposed on their firms and to act at cross purposes with the planners' aims" [16] Since the managers can make correct decisions only on the basis of correct prices, further decentralization without price reform would be most dangerous Increasing freedom for the managers must go hand in hand with a reform of the price structure

(4) A fundamental price reform is considered imperative A draft proposal of December, 1957, recognizes the marginal cost principle and even the need of interest rates for both long- and short-term credits

(5) Individual producing units should be allowed to follow commercial considerations and try to maximize profits through the substitution of cheaper for more expensive factors of production

(6) The decisions of producing units should be taken with the participation of "workers' councils"

These arguments (which were, indeed, Oskar Lange's as Chairman of the Polish Economic Council) seem to throw us back to liberal socialism This time, however, we approach liberal socialism from a criticism of authoritarian planning rather than capitalism When the Polish advocates of decentralized planning came to the conclusion that prices and costs must become indicators for the planners, they seemed to have given up *ex ante* planning However, the decentralists did not want to disintegrate the plan, they wanted merely to loosen it up sufficiently to permit cost accounting and

[15] Cf Alexander Erlich, "The Polish Economy after October, 1956 Background and Outlook" *American Economic Review*, XLIX (May, 1959), 96

[16] John Michael Montias, "Price Setting Problems in the Polish Economy," *The Journal of Political Economy*, LXV (December, 1957), 489 Montias cites the following examples "Coal was sold to state plants at such a low price that it did not pay to store it properly or to burn it efficiently at the cost of extra man hours of work *Even though wood was in short supply, lumber was so cheap that socialized* building firms did not find it worth while to tear down temporary scaffolding or to break up forms for pouring concrete and use the wood over again Oak served for the floors of cheap housing developments, while the output of plastics and linoleum was moving forward at an insufficient pace, hampered by high costs in relation to 'natural raw materials that had been priced too low Much steel was wasted because mill managers did not find it to their advantage to turn out lighter rolled products with more exact specifications and there was no incentive for 'project bureaus' to design machines consuming less steel"—*Ibid*, pp 489-490

freedom of managerial decision within the framework of planned development programs.

We know already that innumerable difficulties arise whenever we try to combine freedom of managerial decision with central planning. It is doubtful, too, whether a sufficiently flexible pricing process can be instituted when those in power do not trust the price system "to ensure that what is needed will be ready at *the right time, at the right place, and in the right* quantities." [17]

Decentralization in Poland has, in the main, been limited to the dissolution of the collective farms. The connection between the agricultural and industrial sectors is again entrusted to market forces; thus at least a partial return to "genetic" planning is indicated. However, no fundamental change has as yet occurred within the industrial sector. "Those workers' councils which took their right to participate in management seriously were quick to find out that there was very little left for them to manage because all crucial decisions continued to be made outside the enterprise. . . ." [18]

Yugoslavia has been experimenting with what has been called "market syndicalism." [19] The departure from Soviet practices is even more pronounced than in the Polish case. Producing units are managed by workers' committees who are, supposedly, free in their price and output policy. They do not fulfill centrally planned output quotas; rather, they draw up their own production plans. They aim at profits, which they are permitted to use for investment purposes or for payments to their workers. Intervention by the government is, of course, possible. As a matter of fact, intervention becomes imperative where syndicalist management leads to *monopolistic price formation.*

At the moment it remains an open question whether this form of decentralization can be combined with *ex ante* planning or whether the advantages of decentralization are not overcompensated by monopolistic practices. Furthermore, the system is endangered by feuds between workers' councils and managing directors, for the latter are responsible to the government, whose aims, of course, need not coincide with those of the workers.

The system offers an interesting example of a dual wage system in which the "calculated wage" set by the government as basis for cost accounting differs from the "contractual wage" set by workers' councils for actual wage payments. Producing units pay the government interest on fixed capital and on short-term credits; and they likewise pay a standard rate of depreciation. In these respects Yugoslav market syndicalism is a far cry from primitive

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[17] See above, Chapter 18, pp. 221-222.

[18] Erlich, *loc. cit.*, p. 103.

[19] Cf. Benjamin Ward, "Workers' Management in Yugoslavia," *Journal of Political Economy*, LXV (October, 1957), 373-386; "The Firm in Illyria: Market Syndicalism," *American Economic Review*, XLVIII (September, 1958), 566-589.

syndicalism It is still very doubtful, however, whether difficulties, both within the system at large and within the syndicalist unit, can be ironed out and decentralization be made compatible with *ex ante* central planning.

Conclusion

The success of the Soviet economy is outwardly quite impressive, particularly as seen by poor countries which want to develop their economies in the shortest possible time Bureaucratic frictions and noneconomic factor allocations are not as visible as grandiose development schemes, full employment, and a high rate of accumulation The construction of whole new industries, ambitious educational programs, the production of sputniks etc, are signs of a tremendous collective effort which seems to compare favorably with the investment efforts of a private enterprise economy

Much of this glamour is the work of propaganda It is easier to glorify the concerted investment efforts of a centrally planned economy than the diversified actions of thousands of competing capitalist firms However, it is true that the mere size of capital accumulation, relative to a country's wealth, will most likely be greater in a totalitarian system which has the power to enforce a relatively low standard of living The durable investment goods so created are more visible and more impressive than the additional happiness which a higher standard of living would have created

It would be fruitless to try to compare the total economic results of systems which are as different as liberal capitalism and authoritarian socialism Production indices can never tell the full story This story would have to include references to enforced efforts and human happiness forgone, items which are utterly beyond the grasp of the statistician In peacetime a democracy will never be willing to force accumulation as hard as does the dictator A dictatorship may, therefore, grow more rapidly in productive capacity But the sacrifice will be very great, since it must be assumed that much of the authoritarian socialist effort is wasted through technological rather than economical allocation of the productive resources

CHAPTER 20

AUTHORITARIAN CAPITALISM: GERMANY 1933-1945

War Economics

During World War II democratic market economies were subjected to a degree of central planning which would be impossible in peacetime. Strange as it may seem, total war simplifies the economic problem. Consumers' sovereignty and even free choice of occupation can be abolished if they interfere with the one and only aim of winning the war.

Theoretically, a market economy at war could still rely predominantly on the price system. It could reduce consumption, not by rationing and priorities, but simply by transferring sufficient consumers' purchasing power to the hands of the government. The government could then successfully compete for the factors of production, i.e., it would outbid consumers. We could maintain free choice of occupation as long as we saw that the industries which produce war materiel were enabled to compete successfully in the labor market against industries engaged in peacetime production. Needless to say, the government could make the production of weapons profitable enough.

Why, then, are the principles of the market economy not applied in times of total war? Three main reasons can be cited:

(1) The change-over to war production cannot be left to the slow-working processes of the market. The sudden creation or enlargement of a military establishment belongs to the category of tasks where *ex ante* integration of the production processes becomes imperative. It may be that market forces could do the job more economically, but they would take too much time.

(2) The tremendous change which total war necessitates in the pattern of production would lead to enormous changes in the structure of prices.

The ultimate importance of the aim of winning the war would justify paying the most exorbitant prices imaginable for strategic materials Different industries, though technically cooperating, would bid against one another for scarce labor and scarce investment funds Exorbitant price changes would lead to extreme shifts in the distribution of the national income Simultaneously, consumers' goods would become increasingly scarce as a growing share of the national product is diverted to war production. The combination of a changing income distribution and an acute scarcity of consumers' goods would lead to changes in consumers' goods prices which would be considered socially unbearable

(3) The situation just described would develop even if the government succeeded in collecting all the revenue it needed through normal, i e , non inflationary, channels Historical experience, however, has shown that this is practically impossible Even where the operation of market forces has been replaced by direct controls, it has been impossible to avoid inflation Were the government to compete for the needed resources on a free market, *the inflationary impact of total war would become much greater* Inflation would eventually become the main instrument by which to reduce consumption in favor of armament production The distribution of the national income, in both monetary and real terms, would become even more unbearable

This is common knowledge We have only to add that war production itself needs planned integration The general staff will have to think in terms of production priorities, of integration of distribution of available equipment among the different theaters of war, etc This task could not be taken care of by the price mechanism It is doubtful that much thinking in terms of opportunity costs will influence the major decisions of the military leaders A rise in interest rates, e g , would hardly induce a less capital intensive production of missiles

Once we dispense, at least in part, with the market mechanism, we have to replace it by the expedient of direct controls Take the case of gasoline If its price were permitted to increase drastically, the lower income groups would be without adequate transportation facilities But as soon as a ceiling price for gasoline *has been established*, *demand* will exceed supply Ceiling prices, therefore, must be accompanied by rationing Now that only *less* than formerly can be bought at *lower* prices, unused purchasing power piles up in the hands of consumers and looks for outlets in other markets, where newly developing scarcities will soon call for further controls It should also be noticed that ceiling prices reduce the willingness of producers to supply more of the scarce article Production of the more important commodities, therefore, must be guided by central administration rather than by the profit motive

Thus we can see that in the case of a national emergency the capitalist system tends toward central controls and eliminates, to a large extent, the

pricing process. But this does not entitle us to draw the conclusion that central control is superior to the profit system. Whenever we try to satisfy the wishes of consumers we must revert to a comprehensive system of cost accounting which only the market economy can provide. Central control is superior when it is necessary to reach one overriding aim which is so predominant that the economic freedoms normally characteristic of the market economy are willingly dispensed with—even in a democracy. In trying to accomplish this common aim people stop taking their own wishes too seriously. "Freedom is in such danger that, paradoxically, it no longer matters." [1]

Thus we are not entitled to conclude that what was right and possible in war must be right and possible in peace. Nevertheless, war experiences are important for the student of social systems. They prove, first of all, that central administration can be successful if we subordinate our economic freedoms to a single purpose; second, they acquaint us with methods of allocation which can be substituted for the price mechanism; third, they impress upon us that something can be done to achieve full employment; and, fourth, they help us understand some of the basic features of authoritarian capitalism.

Imperceptible Growth of Authoritarian Capitalism

In the preceding chapter we have seen how authoritarian socialism established a centrally planned economy. We shall now discuss the National Socialist economy in Germany (1933-1945) as the most outstanding example of authoritarian capitalism. As in Chapter 19, we are interested in only the main structural features of this economy, which maintained the exterior facade of capitalism. References to administrative detail will be kept to a minimum.

Even less than in the Russian case can we indicate a point of time at which this authoritarian economy emerged. Hitler's system of central administration grew gradually and, to some extent, even without the intention of the responsible leaders. As in Russia, there was no blueprint available. Certainly, the program of the National Socialist German Labor party (NSDAP) cannot be considered as such. In spite of the party's promise that "unearned" income would be abolished, that land would be confiscated without compensation for communal purposes, and that the bondage of interest slavery would be broken, nothing very revolutionary and anticapitalist happened when Hitler came to power. When the National Socialist economy developed into a command economy, it did so via an entirely different route than was suggested in the party program. In outward ap-

[1] Barbara Wootton, *Freedom under Planning* (Chapel Hill: University of North Carolina Press, 1945), p. 89.

pearance the German economy remained capitalist Nevertheless, it changed gradually and imperceptibly until it became a centrally directed economy even before World War II broke out

Whether an economy of central administration should be referred to as capitalism is a matter of terminology Marxists may claim that National Socialism was the logical development of monopoly capitalism, i e, that a change in the political superstructure was necessitated by a change in the mode of production The protagonists of the market economy, on the other hand, are not willing to consider Hitler's command economy a form of capitalism They point out that the National Socialist economy resembled capitalism only superficially, while in essence it was much more like the Soviet system—a centrally directed economy whose production process was no longer guided by market forces

We shall return to this question

Hitler's Full-Employment Policies

Upon coming to power Hitler proclaimed a Four Year Plan for a "con certed and all embracing attack on unemployment "[2] The measures to be employed to that end differed only in degree from those adopted by democratic governments The gist of the German recovery policy, "initial ignition' via government deficit spending, had the express purpose of stimulating *private* investment Government spending and tax remission were to taper off as soon as private consumption and investment became strong enough to guarantee a high level of employment[3]

In 1933 1934 Hitler was vehemently opposed to increasing government interference His aim was to increase aggregate spending and to put to work forces which are now referred to as multiplier and accelerator[4]

The initial ignition program was a failure as far as the effects of deficit spending on private investment were concerned. Business did not react favorably, it did not trust a regime that had come into power on a socialist program Indeed, the radical wing of the National Socialist party interpreted the whole recovery policy as a short run concession to momentarily indispensable capitalist forces

There was a more important reason for the recovery program's failure it was too inflation-conscious and therefore, not courageous enough This cautious attitude expressed itself throughout the whole period 1933-1945 Wages were kept at the very low levels to which they had fallen during the

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[2] *The Speeches of Hitler, April 1922 August 1939,* ed by Norman H Baynes (London Oxford University Press, 1942), p 114

[3] See Chapter 9, above, pp 100 101

[4] See Chapter 8, above, pp 87-89

preceding depression. Increasing consumer purchasing power was supposed to result from increasing employment and not from increasing wage rates. The wage-price spiral was to be avoided at all cost.

Here we meet a decisive difference between the German recovery policy and the full-employment policies which were followed in democratic countries. Only a totalitarian regime can combine a low-wage policy with general economic expansion. Democratic governments have to accept the results of collective bargaining. But a low-wage policy does not go well together with the intention of stimulating private investment via the multiplier effect. Inflation-conscious, Germans saw the multiplier as that dangerous velocity of circulation of money which played a decisive part in the German hyperinflation of 1923.

An interesting detail of the German work-creation program was the establishment of a special committee, under H. Schacht, with dictatorial powers in all financial matters. The committee determined the extent of credit creation, being empowered to halt the whole employment program at the first signs of price inflation.

As a result of its cautious nature the early Nazi recovery program mostly benefited *primary* employment, i.e., employment created in industries and on projects where government funds were directly expended and in industries which supplied them with raw materials. As has been mentioned, *secondary* effects on private investment were at first highly desired but were not readily forthcoming. Much of the money earned was not spent again but was used instead for the repayment of debt or for building up new savings; this constituted a leakage in the multiplier effect.

Since private investment was not willing to take over, the government had to shoulder an ever-increasing investment burden in an effort to reach, and maintain, full employment. However, the situation could have been saved by any other large-scale investment program. As a matter of fact, such investment programs (in housing, road construction, etc.) competed heavily with armaments up to the beginning of World War II.

By 1935 the National Socialists had realized with satisfaction that the failure of private business to recover was not so bad after all. Increasing private investment in the consumers' goods industries would soon have been incompatible with the regime's growing ambitions.

Elimination of the Pricing Process

During the beginning of the recovery period (1933-1934) Hitler still emphasized the importance of economic freedom. The economy had to be liberated "from the chaos of oppressive regulations and of restrictive measures" which were "stifling economic life." He also said that "the initiative

thus taken by the State had always solely as its aim and purpose to awake private economic initiative, and thus slowly to set economic life once more on its own feet " [5]

But as early as 1935 Hitler admitted that the National Socialists had taken the path to a planned economy, "a perilous adventure, for planned economics lead to bureaucratic control and thus to the suppression of individual creative effort " In the same speech he gave a good picture of the planned character of the German economy in 1935

> What we have achieved in two and a half years in the way of a planned provision of labor, a planned regulation of the market, a planned control of prices and wages, was considered a few years ago to be absolutely impossible In order to guarantee the functioning of the national economy it was necessary first of all to put a stop to the everlasting oscillations of wages and prices It was further necessary to remove the conditions giving rise to interference which did not spring from higher national economic necessities, i e, to destroy the class organizations of both camps which lived on the politics of wages and prices [6]

Though the planning measures at that time were still mild in comparison with what was to follow, one cannot miss the authoritarian attitude in the passage quoted above It had not taken much time to move from a policy of stimulating private enterprise to a policy in which any expression of economic freedom by citizens was frowned upon as ' interference "

Hitler was probably indifferent concerning which methods were used, as long as his aims were achieved By 1935 he was politically ready to start his armament program, and to make a great effort to become as independent as possible from foreign supplies Hitler was aware that these programs were another big step in the direction of central planning, but he argued that it was ' a question of existence or non-existence " [7]

When Hitler declared that "in order to guarantee the functioning of the national economy it was necessary first of all to put a stop to the everlasting oscillations of wages and prices," he rejected, perhaps unconsciously, the very basis of the market economy For guidance through prices he substituted a constantly growing number of direct controls, which, after some coordination and integration, amounted to a system of central economic administration

The wishes of the people (whether as consumers, workers, industrialists, or farmers) were considered "interfering ' when they tended to clash with the aims of the "nation " And since the wishes of the people found expression in price and wage movements, these market reactions were sup-

[5] *The Speeches of Hitler*, I, 886
[6] *Ibid*, pp 910-911
[7] *Ibid*, pp 927 928

pressed and replaced by administrative procedures through which the economy could be made to conform to the dictator's wishes.

Such administrative controls suggested themselves also as a method of stemming the much-feared price inflation. Price inflation could be repressed by command, could be forbidden. But since it is very difficult to stabilize the general price level and still let individual prices fluctuate, the price stabilization program implied the abolition of price and wage oscillations. Because these oscillations were considered "interfering," anyhow, they were sacrificed without regret.

We cannot discuss in detail the frequently changing price regulations by which the National Socialist government tried to combine anti-inflation policies with central production control. The policy was not uniform and grew in scope and rigidity as full employment and rearmament made the German economy more vulnerable to price inflation. The freezing of the price pattern proved so stifling that it necessitated more and more direct controls if production was to continue. We have already seen[8] that repressed inflation can be even worse than open price inflation. In an open inflation, price relations, though distorted, are still the result of market forces, while the frozen prices of a repressed inflation gradually lose all connection with reality.

To prevent private firms from producing for wrong markets (guided, as they were, by wrong prices), price controls had to be accompanied by direct allocations of productive resources and by stringent investment controls.

We turn now to some of the more important controls which replaced the working of market forces in the National Socialist economy.

Wage Controls and the Allocation of Labor

We saw that Hitler maintained a low wage level as a basis of inflation-proof expansion to full employment. The achievement of full employment did not lead to a change in this policy On the contrary, his determination to keep wages low was strengthened by the realization that labor's position in a sellers' market would be too strong if collective bargaining were permitted. On the whole, wages were kept at the depression level of 1933, but increasing employment led to increasing total earnings.

The Law for the Regulation of National Labor (1934) eliminated collective bargaining and established the "leadership principle" in each enterprise. The owner or manager of the firm was the "leader," who cooperated with his employees as "followers" for the benefit of the people and the state. The "leader" determined the conditons of work, including wages. In this task he was advised by a "confidential council" selected from, but

[8] See Chapter 9, above, pp. 108-109.

not elected by, the "followers" Although the council could not overrule decisions of the "leader," it could, in case of conflict, appeal to the so-called "trustee of labor," a government official

Thus it seemed as though the breaking-up of labor unions and the abolition of collective bargaining had indeed established the employer as the decisive figure in labor relations This impression supported early beliefs that Hitler's aim was the revival of capitalism in its most conservative form.

In reality, however, the "trustee of labor" had unlimited power to dictate the conditions of work, including wages, hours of work, the right to fire, etc Any regulation issued by the "trustee" for his district superseded existing agreements or decisions made unilaterally by the "leader"-manager The 'trustees," of course, had to carry out Hitler's instructions

The government's complete control of labor relations was not restricted by the Labor Front, a party organization which included both employers and employees By no stretch of the imagination could the Labor Front be interpreted as a labor union It was supposed to foster mutual understanding between employers and employees, it supervised vocational training, and it took over some of the cooperative and insurance functions of the defunct labor unions Indeed, it had even less influence than do Russian workers' organizations, which can at least try to influence the plan in its formative stage

Since wage rates were no longer determined on the labor market, labor could not be expected to be automatically guided into industries which needed it most Labor had to be allocated by command free choice of occupation was abolished In 1935 the so-called labor book, a kind of passport which contained a description of the training and career of the worker, was introduced This book had to be handed over to the employer, who, under certain conditions, could refuse to hand it back, thus freezing the worker in his job Labor offices had complete files which enabled them to guide labor according to the government's priorities The Labor Draft Law of 1938, which eventually applied to all inhabitants of Germany, enabled the government to shift individual workers as well as whole gangs of workers from one place to another It should be remembered that these regulations originated in a peacetime economy

Investment Controls

How was private investment to be controlled where private enterprise was left in charge of production? No attempt was made to nationalize even the most strategic industries Nevertheless, the national resources had to be used according to the production pattern which the National Socialist priority scheme demanded

Since private property in the material means of production was main-

tained, government investment in armaments, synthetic raw materials, etc. took the form of an expansion of the productive capacity of private enterprise. Private firms produced what the government wanted, and the government, in turn, saw that the firms got sufficient allocations. An attractive margin between costs and prices was permitted. These profits did not guide production, however, and even their reinvestment was subject to government control.

The coordination of industrial production was entrusted to representatives of the business community rather than to a buraucracy unacquainted with the problems of industry and trade. Since the concentration of economic power had gone far in Germany, this arrangement was relatively easy. Former cartel leaders could now become chairmen of "Economic Groups." Many industrialists were quite willing to wield the additional power conferred upon them as representatives of the government. Private monopoly and public power merged. The aims, however, continued to be those of the National Socialist command economy.[9]

As in Russia, the whole production process of the nation had to be coordinated in one comprehensive plan once guidance through market prices had been abolished. How was this coordination accomplished?

First, it was necessary to collect statistical data for all industries and groups of industries. From these figures had to be derived the physical balances of input and output.

Secondly, these figures and balances had to be used to accomplish the needed over-all integration. Each industry's output had to be seen as the input of other industries. Or, to put it differently, the physical balances for the different economic groups had to be coordinated—an extremely difficult task, as we saw in the discussion of authoritarian socialism. In the National Socialist economy it became customary to concentrate on bottlenecks, i.e., on those spots where severe shortages endangered the plan.

Thirdly, the individual firms were told what, how much, and when to produce. Simultaneously, they were given priorities for the purchase of the materials needed to fulfill these orders.

Finally, constant check had to be kept on the fulfillment of the plan.[10]

The basic similarity between planning procedures in the National Socialist and Soviet economies is not surprising. With the elimination of the price system as automatic allocation procedure, it is necessary to design a conscious process for technological integration of the production processes. That the German planning procedure was less ponderous, less visible, and perhaps somewhat more elastic may be due to the fact that the task was handed to leading businessmen in each field.

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[9] Cf. Heinz Paechter, "Recent Trends in the German Command Economy," *Journal of Political Economy*, LII (1944), 217-233.

[10] See Walter Eucken, *Grundsätze der Wirtschaftspolitik* (Hamburg: Rowohlt, 1959), pp. 61-63.

Our basic criticism must be the same as in the Russian case, viz., that the system could not lead to the most economical use of the means of production because it refused to allocate the factors according to considerations of marginal productivity

Financial Arrangements

The outwardly capitalist character of the National Socialist economy implied financial arrangements which differ from those of the Russian plan The principles were simple Private industry was required to use its profits to finance investments desired by the government In order to pay for armaments, road construction, synthetics production, etc, the government collected a substantial part of the nation's income Whatever additional funds were needed for government planned projects could be borrowed in the credit market, whose organization ensured smooth compliance with the government's will

The work-creation program was financed by so-called work-creation bills These bills were issued by private firms, accepted by the authorities in charge of the projects, discounted by the commercial banks and re-discounted by the Reichsbank In these arrangements we can detect the government's desire to imitate as closely as possible the creation of money on the basis of commercial paper[11] National Socialist financial experts argued that, with the success of the work creation program, the bills could be redeemed out of increasing public revenues Indeed, it was correct to assume that increasing economic activity would permit a substantial amount of credit creation without price inflation The imitation of short term commercial paper was mere rigmarole, however

More straightforward were two other measures The Dividend Limitation Law of 1934 demanded that dividents above 6 per cent be invested in Government bonds, while the Law for the Regulation of Credit (also of 1934) made the whole banking system subject to complete government control

In the spring of 1938 the government stopped using short term bills for fear that credit creation would cause too much inflationary pressure By now the government had full control of the credit market, could enforce the purchase of its bonds, and could restrict the private issue of bonds and shares There was considerable purchasing power which could no longer be spent on consumers' goods and could instead be mopped up for yet another round of Government spending—a typical sign of repressed inflation

It would be interesting to know to what extent the financial arrange-

[11] Cf George N Halm *Economics of Money and Banking* (Homewood, Ill. Richard D Irwin Inc, 1956), pp 117-120

ments of the National Socialists were mere window dressing. Possibly they were meant seriously. The preservation of the capitalist framework of the economy made it necessary to use the financial apparatus of the private enterprise economy. Furthermore, Hitler was deeply concerned about possible inflationary developments. It is possible, however, that the National Socialists, underestimating the economic powers of a totalitarian regime, were overconcerned about monetary problems and that Hitler was much more timid in the field of finance than in his political and military ventures. Thus, by the irony of fate, Hitler's monetary scruples may have helped to win the war for his enemies.[12]

In connection with the discussion of financial matters it should be mentioned that, once in power, Hitler did nothing to abolish the interest rate as unearned income, i.e., to abolish the "thraldom of interest." However, the system of central administration deprived the rate of interest of its important function of allocating investment funds in the most economical manner.

Agriculture and Foreign Trade

Next to the creation of full employment, Hitler most wanted to improve the position of the farmer. "Within four years," said Hitler on February 1, 1933, "the German peasant must be rescued from the quagmire into which he has fallen." [13] Furthermore, Germany's supply of food and raw materials was to be made as independent as possible of foreign sources.

As early as 1933 the whole agricultural sector of the German economy had been organized in the so-called Reichs Food Estate, a "self-administered" statutory corporation which included all persons connected in any way with the production, processing, and distribution of agricultural products. The term "estate" gives to this and other organizations an aura of medieval glory but hinders rather than increases our understanding, for it implies an autonomy which the estates did not enjoy. They were organs of the central administration.

It was relatively easy to eliminate price fluctuations in the field of agriculture. Strict regulation of agricultural imports and exports could largely adjust supply to demand, while remaining domestic oscillations in supply could be offset by government sales and purchases. The farmer paid for this protection against price fluctuations by having to accept innumerable bureaucratic controls. The nation as a whole paid for increasing self-sufficiency through sharply increasing production costs, i.e., through loss of the advantages of international division of labor.

A centrally directed economy with price and production controls can-

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12 See Burton Klein, "Germany's Preparation for War: A Re-Examination," *American Economic Review*, XXXVIII (March, 1948), 73.

13 *The Speeches of Hitler*, I, 114.

not permit freedom of international trade The planned economy must be protected against unforeseeable changes in exports and imports In Russia the needed insulation against the vagaries of world trade is accomplished through a state monopoly which controls all exports and imports The National Socialist economy achieved virtually the same result through foreign exchange controls Foreign trade was left in private hands, but what the private traders were permitted to do was strictly and minutely regulated by the government

The foreign exchange control measures of the National Socialist economy were fantastically complicated The major principles of foreign exchange control, however, are quite simple to understand Essentially, exchange control is a combination of ceiling prices and rationing on the foreign exchange market The government establishes a price (in terms of its own currency) for the basic unit of each foreign currency For all or most of these currencies, however, the rate established is lower than the equilibrium rate, just as the price of gasoline, in war time, is kept much lower than the market situation justifies The demand for foreign currencies exceeds the supply at the official rate and must be artificially restrained The allocation of foreign exchange through the government leads to imports in conformance with the requirements of the plan Regarding imports the administration has to make four major decisions, viz., "(1) how much to allot for different *purposes* (commodity imports debt service, tourist traffic, etc), (2) how to distribute the exchange available for imports among different *commodities*, (3) how to ration exchange among different *firms*, and (4) how to distribute the total among different *countries*" [14]

In order to be able to allocate foreign exchange to the uses it considers most important, the government must get hold of incoming foreign exchange All exporters must be made to sell their foreign exchange earnings to the government at the official price Since this price is artificially low, exporting is not attractive to private traders and must be stimulated by subsidies which improve the exporter's competitive position on the foreign market

Hitler developed foreign exchange controls into an instrument for the monopolistic control of international trade, the circumvention of commercial treaties, and the establishment of bilateral clearing agreements under which the accumulation of German debts could by itself be used to exert pressure on foreign creditors

The Nature of the National Socialist Economy

Was the National Socialist economy a capitalist or a socialist system? Probably it was neither, it wanted to be quite different from both The

[14] League of Nations *International Currency Experience*, 1944, p 173

Hitler economy can, perhaps, be understood best as a kind of capitalist war economy able to operate in peace time. What democratic countries could do only under the impact of war, the dictator could undertake to do six years before the outbreak of hostilities. The totalitarian regime can dissolve labor unions, abolish collective bargaining, freeze wages and prices, control the distribution of resources—can do all this and more without having to wait for a national emergency in which the people are ready to forgo important economic liberties.

Let us see what remained of the capitalist character of the German economy under Hitler.

(1) The outer shell of capitalism was preserved. The new organizations and controls were not overtly anticapitalist; they were designed to overcome difficulties connected with depression, dependence on foreign supplies, shortages of foreign exchange, inflation, and rearmament. All deviations from the straight capitalist road seemed to be as temporary as the emergencies requiring direct controls. It is understandable that many Germans held the belief that some time in the future all these various controls would be removed to make room again for the operation of market forces.

(2) It would have been possible for Hitler to go back to a system with fewer controls and an increased emphasis on price fluctuations. The basic institutions of capitalism, private property in the means of production and private enterprise, were still preserved. The success of the German "social market economy" after 1948 is proof of the fact that the price system was able to take over.

(3) In several instances the National Socialist economy prided itself as representing a return to a free economy rather than a movement toward central planning. The destruction of the labor unions, the increasing power of the employer as "leader" in all labor relations, the emphatic refusal to nationalize the banking system, and the importance of big business in the administration of industrial production—all these were interpreted as evidences of a "purer" form of capitalism, "purer" in the sense of being more uncompromising and more extreme. Of course, such policies were also more in conformance with the Marxist idea of what capitalism would be like before its downfall.

(4) For many years the leaders of the National Socialist economy continued to think financially in capitalist terms. Indeed, they were unaware of all the economic implications, possibilities, and potentialities of the system of controls which they had created. They learned faster in some instances than in others. Exchange control measures, for example, were exploited to the utmost. Domestic monetary problems, on the other hand, seemed to have worried these leaders more than the facts warranted.

The above points, then, might be used to argue that National Socialism was either a kind of monopolistic supercapitalism or an essentially liberal market economy reluctantly forced to use controls. On the other hand, one

might contend that the totalitarian, centralistic character of Hitler's economy indisputably deprived it of the right to be called capitalist Our views will depend, of course, on what we consider the essence of capitalism to be If, instead of emphasizing the monopolistic character of capitalism, we stress its unplanned character as a market economy which permits consumers' sovereignty and free choice of occupation, we shall consider increasing controls a step away from capitalism While each individual regulation may appear comparatively unimportant, all controls together amount to a complete change in the economic climate

The following points can be made by those who believe that National Socialism must not be identified with (liberal) capitalism

(1) The forces of the market were replaced by direct controls

(2) Much of the capitalist appearance of the National Socialist economy was mere window dressing designed to make the crude fact of a command economy less obvious Its leaders tried to create the impression of a maintenance or even a revival of capitalist principles, while the facts pointed clearly in the other direction The regime was eager to maintain the appearance of personal freedom when, in reality, its citizens had no choice whatever Although membership in the Labor Front, for example, was "voluntary," it was impossible to get employment without membership

(3) Just as the regime could theoretically have reverted to the principles of a market economy, so, too, could it have shed its capitalist skin and shown its true nature as a command economy Private ownership of the means of production is of doubtful significance if production is centrally planned The government could have fulfilled its promise to abolish income unearned by work Since prices, wages, and profits had lost their guiding functions, there was no need to maintain the income distribution that had been inherited from capitalism

(4) The more we emphasize the element of economic freedom in the capitalist market economy, the less can the National Socialist economy qualify as capitalist The question of free choice loses all meaning in a regime which, through its propaganda ministry, controls the minds of the people until they can no longer distinguish what they themselves want from what the government wants them to want Such a system has reached its aim when the people are so thoroughly indoctrinated or intimidated that they "freely" act as the government expects them to act

PART SIX

BETWEEN FREEDOM AND PLANNING

CHAPTER 21

Market Economy and Welfare State

CHAPTER 22

Economic Systems and Underdeveloped Countries

CHAPTER 23

Economic Systems and International Trade

CHAPTER 24

The Agenda of Government in a Market Economy

CHAPTER 21

MARKET ECONOMY AND WELFARE STATE

Introduction

The four chapters comprising the last part of the present volume have this in common: they deal with attempts of politically free systems to combine their free institutions with regulations which encroach on these institutions. Such encroachments may stem from the desire to overcome the weaknesses of capitalism, from the desire to develop underdeveloped countries, and from international trade relations between market economies and planned economies. We shall take up these problems successively. The last chapter tries to show what kind of compromise is suggested by the very nature of the market economy.

The present chapter concerns economies which have in common that they are predominantly private enterprise economies, are consumer-oriented and are, to some extent at least, market economies. To put it differently, they are not centrally planned (like Russia), are not centrally administered (like the German economy under Hitler), and are not based on government ownership of the material means of production (as in the liberal socialist blueprint).

Since a survey of all developed market economies would be much too big a task to undertake, we shall limit our study to two examples: the British economy under the Labor administration and the West-German social market economy.[1]

To understand the problems which faced the free economies after World War II, we have to look back to the period before the war when the capitalist market economies went through the cataclysm of the Great Depression.

[1] For a survey of the market economies, see *Economic Systems of the West* (Basel: Kyklos Verlag; Tübingen: J. C. B. Mohr, Vol. I, 1957, Vol. II, 1959).

Out of this period grew Hitler's economy of central administration, and out of it was born, in democratic countries, a new philosophy lacking faith in the market economy This faith was never quite regained before the outbreak of World War II, and war experiences, in turn, seemed to support those who felt that emergency situations could not be handled by the price system At the end of World War II it was generally believed that the market economy's inability to handle prewar depression problems made it unreliable for the period of postwar transition War destruction, demobilization, retooling of industry, structural changes in world trade, excess purchasing power ("the monetary overbang"), etc seemed to be so many new problems superimposed on the old difficulties After the relative security of wartime full employment most politicians and economists dreaded the jump into the cold water of a free market system Baffling contradictions seemed to lurk everywhere pent up purchasing power would lead to inflation, insufficient investment and mass unemployment would have deflationary effects, the interest rate would have to be low to stimulate private investment, the interest rate would have to be high to maintain monetary stability, prices would have to remain under government control, prices would have to be permitted to change freely, etc

Some countries, finding themselves in the predicament of having neither free markets nor central planning to rely upon, had to temporize, as best they could, with a host of uncoordinated direct controls Others abolished their price and production controls before they had reconstructed their monetary systems, and they consequently paid the price of inflation Still others dealt decisively with the monetary problem, dismantled controls and trusted markets and private initiative

Behind these different policies stood differences in philosophy in which we could be tempted to discover the old socialism-capitalism controversy were it not for the following facts

In discussions of the market economies of the West the term "capitalism" is now often avoided This is not only true for countries whose administrations are controlled by socialist parties but also for countries which are trying to come as close as possible to the model of a free market economy West Germany, for instance, refers to its economic system as social market economy and not as capitalism

Thus the term "capitalism" has largely disappeared from the discussion, whereas the term "socialism" is still in use, despite the fact that maintenance of private property and private enterprise implies a market economy and does not fit the older definitions of socialism Although the economic essence of capitalism has been preserved, everybody dissociates himself from the connotations of the term, and while the meaning of socialism has been diluted beyond recognition, the term continues to be used because of its connotations of equality, welfare, and planning

The rejection of the term "capitalism" indicates that all modern market

economies are to some degree welfare economies. Although there may be substantial differences in degree, *all* modern market economies want to regulate the market. We shall see that the main difference between our two case studies concerns less the aims than the methods. From the socialism-capitalism controversy the problem has changed to a conflict between the advocates of many direct controls and those who want to limit needed regulations as far as possible to indirect measures which do not disturb the price mechanism. The British economy under the Labor administration will serve as illustration of a market economy which is regulated by many direct price and investment controls; the economy of West Germany will be the example of a market economy which tries to reach its objectives by reliance on a competitive pricing process.

As in the discussion of Russia and of Hitler Germany, no attempt is made to offer a complete picture. Our interest is focused on the issue of consistency. We shall see that the West German economy is, in this respect, superior to the British economy under the Labor government. This statement implies no value judgment about the aims of either system; nor is it impaired by the admission that many influences were at work which had nothing to do with the differences in economic policy.

Disappointment in Nationalization

The statement that the market economies of the West have in common the preservation of private enterprise rests on the fact that in none of these countries has nationalization been carried forward to a considerable degree. Socialist economists in England have pointed out that the nationalized sector of the British economy will always remain a minority of the whole,[2] and that it would be an error to equate socialism and nationalization.[3] The reason for this reserved attitude toward what at one time seemed to be the most important point in the constitution of the Labor party (1918) can be found in the following circumstances:

(1) Probably most decisive was the realization that the state can achieve its main economic purposes by control—without public ownership

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[2] Francis Williams, *Socialist Britain* (New York: The Viking Press, Inc., 1949), p. 91.

[3] See, e.g., W. Arthur Lewis, *The Principles of Economic Planning,* A Study Prepared for the Fabian Society (London: Dennis Dobson, Ltd., 1949), p. 10; Oliver Franks, *Central Planning and Control in War and Peace* (Cambridge, Mass.: Harvard University Press, 1947), p. 20. German socialists, too, have turned away from nationalization. On November 15, 1959, the Social Democratic party adopted a new program which "makes it absolutely clear that public ownership is but one means to protect the freedom of the individual against the predominance of uncontrolled powerful interests . . . and the new formula therefore reads, 'As much competition as possible—as much planning as necessary.'"—*The Bulletin; A Weekly Survey of German Affairs,* Bonn, November 17, 1959.

—of the means of production Not all members of the Labor party agree, however, and the majority who do agree differ in what they mean by control We shall have to differentiate repeatedly between those controls which are compatible with the market economy, and work, as it were, through the market and those controls which inhibit the working of market forces The contrast between the British and German cases which we are about to compare lies mainly in this different concept of the role which the state should be made to play

(2) Since the socialist parties of the West do not advocate revolutionary methods, nationalization implies compensation for former owners, a fact which makes it less attractive

(3) The organizational problem regarding nationalized industries has proved difficult in practice Hugh Gaitskell doubts that "there is any escape from the dilemma that the more independent the boards (of nationalized industries) are allowed to be, the more they will exercise power without responsibility, and the less independent they become, the greater the risk of over-centralization and lack of enterprise " [4]

(4) The general economic consequences of even the modest amount of nationalization which was carried through and maintained (coal, electricity, transport, central banking) have not been favorable Prices were set below equilibrium levels, costs were not sufficiently considered, capital was invested at artificially low rates of interest and labor employed at artificially high wages, and losses were covered by the state Investment funds and productive resources were consequently wasted [5] If the nationalized area of the British economy were to be considerably enlarged, this interference with the price system might grow to major proportions At the same time a central plan might not be available to see that at least technical consistency is maintained throughout the economy

(5) If the remaining enterprise sector is to perform effectively, private enterprise must feel confident that it will not be nationalized, the sword of Damocles must not be left dangling over it Commenting on the transition from capitalism to socialism, Oskar Lange expresses the belief that if nationalization is contemplated at all, it should be the first rather than the last step He says,

> The opinion is almost generally accepted that the process of socialization must be as gradual as possible in order to avoid grave economic disturbance . . Unfortunately, the economist cannot share this theory of economic gradualism An economic system based on private enterprise and private property of the means of production can only work as long as the security of private property and of income derived

[4] Hugh Gaitskell *Recent Developments in British Socialist Thinking* (London Co-operative Union, Ltd., 1956), p 14

[5] See G C. Allen, "The British Economy," in *Economic Systems of the West*, I, 75

> from property and from enterprise is maintained. The very existence of a government bent on introducing socialism is a constant threat to this security. Therefore, the capitalist economy cannot function under a socialist government unless the government is socialist in name only.[6]

(6) The reasons advanced for the nationalization of industries are not particularly impressive. The "basic" industries argument fails to define what is basic. The monopoly argument is exposed to the criticism that nationalization intensifies the monopolistic character of an industry and that it is doubtful whether management would be improved in practice. The argument that unified administration can better integrate an industry requires that the gains from better organization are not lost through increasing bureaucratic friction. Finally, the distressed industries argument often wants to keep alive via nationalization industries which are rightly declining in response to changed demand or cost schedules. Other arguments, which urge nationalization as a means of attaining ends like full employment and equalization of income, are poor because the aspired ends can be better achieved by other means.

Since the British Labor party has shown no interest in further nationalization, with the single exception of steel, it can claim only a very diluted kind of socialism as its aim. But the British socialists who now want to achieve central planning within the framework of a private enterprise economy will have to prove that the shortcomings of authoritarian capitalism—rather than authoritarian socialism—can be avoided. That the decisive issues are often not clearly understood can be seen in the proposal that the government should gradually acquire the ownership of private industry through the acquisition of equity shares. When Hugh Gaitskell suggests that the government may do this "without necessarily exercising detailed control even over an industrial firm—much less a whole industry," [7] he minimizes a difficult practical issue. Is it not probable that this "backdoor" nationalization will be used to accomplish aims which are incompatible with the private enterprise economy? Is it not likely that, once the state owns the majority of shares in both firms and industries, they will be expected to operate according to a tripartite system (used in some nationalized enterprises in France) reflecting the views of representatives of employees, consumers, and the state? If so, is it not further likely that the views of these diverse interests will prove so irreconcilable that finally leading technicians will have to make all important management decisions?

We assume in the following pages that in the Western democracies there is little desire to push nationalization much further, that private enterprise

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[6] Oskar Lange and Fred M. Taylor, *On the Economic Theory of Socialism* (Minneapolis: University of Minnesota Press, 1938), pp. 122-123. Copyright 1938 by the University of Minnesota.

[7] Gaitskell, *op. cit.*, p. 35.

is in charge of most production processes and that private decisions are basically free

Aims and Policies of the Labor Party

British socialists are so concerned with securing greater income equality that they have sometimes seemed to neglect the problem of securing a larger national "cake and instead to concentrate exclusively on the problem how it should be "cut" They pursued a more egalitarian distribution from several sides simultaneously

(1) Equalization through taxation This attack on inequality has already gone rather far, considering that the British economy must still rely on private initiative and private saving We have already seen, furthermore, that excessively progressive taxation begins to interfere seriously with the proper division of labor

(2) Equalization through government spending Although the measures which fall into this category (e g , free health service) may be controversial when considered separately, or too expensive and inflationary in the aggregate, they are basically compatible with the market economy

(3) Equalization through control of food prices As an equalitarian and anti inflation measure this policy is roundabout, wasteful and clumsy British food subsidies violated the basic principle of consumers' sovereignty, distorted the price structure, and invited waste Furthermore, inflation should be attacked by removing its causes rather than by trying to cure its symptoms

(4) Equalization of opportunity This attack on inequality—which is compatible with the principles of the market economy—goes to the very root of the problem Free education will increase productivity and the size of the distributable income

The British economy enjoyed full employment during the Labor administration, but it maintained this high employment level by policies which were inflationary and which tended to perpetuate the dollar shortage that had been inherited from the war Full employment conditions, furthermore, strengthened the bargaining position of the trade unions and made it impossible for the Labor party to resist their pressure for higher wages and shorter hours Downward adjustments of wages became next to impossible When this tendency toward higher wages is added to the egalitarian policies of the government, it can be seen that consumers' demand pressed strongly for a larger share of the nation's income at the expense of investment and the ability to export

Wage negotiations could not have led to constantly increasing wages if they had been conducted within a monetary framework which was not indefinitely expansible The monetary authorities, however, made available

whatever amount of purchasing power was needed for full employment to be maintained in spite of rising wage rates. Insistence on a stable value of money would have created some counter pressure on the labor market, for above a certain point rising wages would have caused unemployment. The full employment policy, however, was sacrosanct.

A policy of monetary stability has to rest on a rate of interest which is high enough to limit credit creation to noninflationary proportions. This rate would have been much higher than the one the Labor administration permitted to prevail. A high rate of interest was not excluded merely to prevent unemployment. An even more direct reason was the unwillingness of the Labor administration to have its investment program restricted. But by following a cheap money policy, the government made "itself responsible for substituting some control in place of the brake that high rates of interest otherwise impose on capital projects." [8]

The Labor government wanted to plan investment, i.e., "to lay down general strategy in the economic field and to see that the over-all strategical plan is followed without interfering too closely with the tactical decisions of the commanders in the field." [9] However, the aims of the government's investment "plan" were exceedingly vague, and this is not surprising in an economy which did not have an apparatus for central planning and which was still predominantly a private enterprise economy. Indeed, how can investment priorities be arrived at under these conditions?

> Who is to decide between the relative urgencies of a new bridge in Basutoland, a new hospital in Aberystwyth, a new mousetrap factory in Glasgow, or a new cinema in Oxford? The answer is that nobody can decide, and that therefore conscientious officials, fully knowing that they have not the facts on which to base a judgement, will pass everything that seems on the face of it to be reasonable. The result is always that more licenses are granted than the available resources can fulfill, and that there is an unholy scramble in the course of which many of the most urgent projects are held up because the promoters of the less urgent have been more skilled in the arts of acquiring scarce materials.[10]

These problems could have been avoided if a proper rate of interest had been chosen. But if, for example, a rate of 3 per cent was maintained when the rate should have been 10 per cent, investment funds tended to be kept from the most urgent needs, such as exports, and spent on such long-term projects as railroad electrification.[11] In addition, cheap interest rates created

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[8] Roy Harrod, *Are These Hardships Necessary?* (London: Rupert Hart-Davis, Ltd., 1947), p. 33.
[9] Williams, *op. cit.*, p. 92.
[10] Lewis, *op. cit.*, pp. 56-57.
[11] Cf. Harrod, *op. cit.*, p. 78.

inflationary pressures which necessitated price controls, just as investment according to priorities required the establishment of a licensing system

The investment policy of the labor government shows lack of a thorough understanding of the allocation problem While vaguely playing with ideas of "planning," the Labor administration gave little thought to the question of how priorities can be established and the proper integration of production processes accomplished short of a full fledged central plan The government's development program did not constitute a well-integrated whole The British economy at that time rested neither on central direction nor on a free market process

The controls by which the government tried to ensure the cooperation of private industry were to a large extent inherited from the war

> The doctrinaire belief in the planned economy made the Government reluctant to remove these controls however unsuitable they might be for peace time purposes But, in the absence of resolute attempts to deal with inflation directly, these controls had to be retained and even extended As the maldistribution of resources increased, more and more detailed State intervention seemed to be justified in the day to-day working of industry The net output of finished goods from the labor and raw materials available was much lower than it would have been in a free market purged of the inflationary pressure So that a controlled economy which had been accepted for political reasons now seemed to be essential on grim economic grounds The vicious circle was complete Inflation unattended to, controls over the distribution of resources to prevent price rises, maldistribution of resources because of the inherent clumsiness of controls, dwindling production intensifying the inflation, more controls and so on, endlessly [12]

The Labor government, trying to find its way back to expanding, multilateral world trade, rejected regionalism, but its domestic policies were not always suited to support this attempt To bridge the postwar dollar gap exports had to be increased in relation to imports We have already seen, however, that domestic consumption and investment, which tended to reduce excessively the volume of goods available for export purposes, led to inflationary pressures which made it difficult to sell abroad

To meet this problem, too, the Labor government relied on direct instead of over-all monetary controls, again it tried to cure symptoms rather than the cause To prevent the easy sale of merchandise at home, the government prescribed for each potential export industry the proportion of its output which it had to sell abroad What the price mechanism would have handled according to the wishes of foreign buyers, the government tried to

[12] John Jewkes *Ordeal by Planning* (New York The Macmillan Company, 1948), p 77

do by dividing the country's output between the domestic and foreign markets. The mistake was the same as in the government's investment policy: an unnecessary bureaucratic apparatus was created to solve a problem which market forces, unimpaired by inflation, would have solved automatically.

Trying to Do Too Much

If we consider British consumption, investment, and export policies as a whole, we see that the basic weakness was that the Labor government tried to do too much. This tendency would have led to price inflation had not the government maintained rather strict and numerous price controls. Price controls, in turn, made it necessary to replace the selective function of the market with direct quantitative controls, and these direct controls were so awkward and uncoordinated that they in turn decreased efficiency, thereby further increasing the inflationary pressure and the disequilibrium in the balance of payments.

It is difficult to understand why the Labor government chose this unsatisfactory way of unpopular "nuisance" controls. At a time when the theory of socialism had come to understand that a price system would have to be artificially created in event of government ownership of the material means of production, the Labor government tried to handle its problems without the guidance of prices. It did so in spite of the fact that maintenance of private enterprise made use of the price mechanism easy.

If our diagnosis is correct, if the basic trouble was that the government was trying to do too much with inadequate methods, then the British policy can hardly be referred to as "austerity." The British people voted themselves a higher standard of living than the economy's productivity permitted. In addition, they aggravated the situtiou by investing too large a part of their resources in time-consuming projects which could have been postponed.

No doubt, many difficulties arose out of the fact that Britain's position in world trade had undergone a structural change. The price and exchange mechanism alone would not have sufficed to solve *all* of Britain's postwar problems. It must also be emphasized that many of the social aims of the Labor party were achieved and became a permanent feature of the British economy. Our criticism must be tempered by these two considerations. Nevertheless, the Labor party's economic postwar policy can be considered as yet another example of the difficulties which must arise when market forces are constantly interfered with by direct controls without the benefit of a central coordination of these controls.

Barring total nationalization, the way out of these difficulties leads in two opposite directions: government controls can be expanded and integrated

until an economy of central administration is established, but democracies will use this road only in the event of total war, or the government, realizing the importance of the market, tries to limit its economic policy *in the main* to indirect (monetary and fiscal) controls which support the price mechanism rather than interfere with it.

Needless to say, we are dealing here with broad generalizations and basic philosophies rather than pure types and clear-cut distinctions. Keeping this in mind, we may consider the case of West Germany as that of a country which chose to rely heavily but not exclusively on the forces of the market. To this case we shall now turn.

West Germany's Social Market Economy

We saw that after World War II the impression prevailed that emergencies have to be met by special measures outside the price system, that the market cannot be trusted to adjust to sudden changes, and that direct controls are imperative in proportion to the emergencies which must be met.

Applied to postwar Germany, this recipe would have meant maintenance of a centrally controlled economy and, at best, a very gradual transition back to the principles of a market economy. What actually happened was the opposite.

Nowhere in the Western world was the economic situation so desperate, and apparently so hopeless, as in Germany between 1945 and 1948. The cities were heaps of rubble, the transportation system was destroyed, production and distribution were almost at a standstill. Even when, with the aid of the occupation authorities, a semblance of order was established, the situation was still bleak. The country was partitioned, and the Western part was the aim of an endless stream of refugees from the East. Inflation could no longer be repressed. Food rations were insufficient. Work at official wage rates offered little incentive when barter transactions in black markets were both more profitable and necessary for survival anyhow. Even industry had to employ barter methods—at tremendous cost in terms of productivity. The mark had ceased to function as a unit of account and was practically repudiated as a means of payment.

This situation was changed overnight through the currency reform of June, 1948, in which the supply of money was cut down decisively to match the supply of goods without excessive price inflation. A currency reform would have been necessary in any case; even a system of central control would have needed a complete reconstruction on the basis of a new monetary unit, though it is difficult to see how a new pattern of official prices could have been found without the aid of free markets. Whether a currency reform would have been successful within a system of central administration we do not know, for the currency reform in West Germany was con-

nected with a basic change of economic philosophy: the return to a market system.

Why did West Germany return to the principles of a market economy, and what kind of economic system was to be constructed?

It should first be stated that the choice was by no means unanimous. The Social Democratic party was vehemently opposed, and the occupation authorities were cool and skeptical. But the country at large had had enough of controls. Controls had characterized the Hitler regime, which had gone down in defeat; after the war, controls had failed to achieve their purposes and instead led to an unbearable psychological situation, where, in the face of a tremendous reconstruction job, all personal initiative was blocked. The population was willing to give the market system a try. Nevertheless, great courage was required of the political leaders responsible for undertaking an experiment which ran counter to the nearly unanimous opinion of politicians and economists throughout the world. How did these German politicians reason?

Alfred Müller-Armack, who coined the term "social market economy," argued as early as 1946 roughly as follows:[13]

The market economy antedates the philosophy of laissez faire. The essence of the market economy is that all economic processes serve the consumer, whose preferences guide production via price signals. But liberalism (which in the European sense means a philosophy close to laissez faire) is not acceptable any more. It made the mistake of regarding the market process as a satisfactory order of a nation's economic life; it was not concerned with the economy as a whole; it was willing to leave the competitive process free to exclude competition itself; it equated the distribution which the market brought about with the distribution that was socially just; it wanted market forces to take care of business-cycle problems; in short, it considered the market process as an end, when that process should have been considered merely as an instrument.

For these reasons "liberalism" was discarded, and the basic principles of the market economy were discarded with it. The place of the market economy was taken by an economy of "dirigism" (Lenkungswirtschaft). But dirigism did not work well even under a dictatorship, for it eliminated the market process and thereby the possibility of consistent economic accounting.

Neither the old-fashioned "liberalism" nor the dirigism of a central administration are acceptable to Müller-Armack. As a synthetical third solution he suggests that the market serve as a supporting framework for the economy but that the market be consciously managed. Such an economy is not limited to any particular aims, and its aims might be the same as those of a welfare state (e.g., avoidance of monopolistic exploitation, high

[13] Alfred Müller-Armack, *Wirtschaftslenkung und Marktwirtschaft* (Hamburg: Verlag für Wirtschaft und Sozialpolitik, 1947).

employment level, social security) The important thing is that these aims are to be reached by policies which are compatible with the market economy, i e, which work through the market rather than against it. All policies which are not compatible with the market framework should be excluded

The group of economists who, like Muller-Armack, favor a social market economy call themselves "neo-liberalists," implying thereby that they do not recommend merely a return to a free price system They reject laissez faire and advocate indirect controls in the form of monetary and fiscal policies, together with "rules of the game" for various market parties The price system is to be freed from those government controls which tend to distort the economic accounting and allocation process, but it is also to be protected against interference from private monopoly

These ideas are very similar to those which eventually prevailed in other countries once the shortcomings of direct controls became evident The West German case, however, is outstanding for the following reasons

(1) Coupled with the currency reform, the new philosophy made an instantaneous impact Practically overnight the economic climate was changed

(2) The success of the social market economy was achieved under conditions which seemed hopeless Indeed, the success appeared to be an "economic miracle" to those who had considered the price mechanism obsolete

(3) The neo-liberalists, instead of introducing more and more controls *ad hoc*, established one guiding principle and then clung to it however unpleasant the results were in individual cases They entrusted to the market the solution of problems which they felt the market could solve better than a great number of bureaucratic controls could While controls were not entirely absent, they became the exception from the rule

(4) The new policy effected a rapidly rising increase in income, a high employment level, and a satisfactory development of West Germany's balance of payments

The Germans were receptive to this new policy because of their past experience with two inflations, one open and one repressed By 1948 they were perhaps more immune to inflationist ideas than were most other countries Furthermore, the Hitler economy of central administration and its final breakdown had created a sense of frustration which strongly favored freedom and a release of pent up energies Against the background of dirigism and inflation, the social market economy appeared as the rebirth and vindication of the basic principles on which an unplanned economy has to rest.

The Success of the Social Market Economy

Several factors which contributed to the success of the social market economy were of a fortuitous nature They were important, and perhaps even

decisive, since they counterbalanced some of the difficulties which stood in the way of a revival of the German economy. Foreign aid partly offset the cost of occupation and reparation; the partition meant that West Germany could buy food in the world market at better terms of trade; the productive capacity damaged by war was probably less than the capacity constructed during the war; and the world market situation was particularly favorable for German exports, while German import demand proved to be less formidable than might have been expected. The foreign trade situation, however, cannot be ascribed entirely to fortuitous conditions, for the volume of exports and imports was greatly influenced by West Germany's domestic economic policy.[14]

To find the main reason for the success of the social market economy we must look beyond the above factors.

The twin birth of the social market economy and the new German currency indicates the importance of monetary stability. Ludwig Erhard, who is the person most responsible for the success of the social market economy, considers currency stability the mainstay of the new system. He believes that "the social market economy is unthinkable without a consistent policy of currency stability" because "only this policy guarantees that groups of the population do not enrich themselves at the expense of other groups." [15]

We have seen that inflationary developments played a decisive part in the British control system: low interest rates and pressure for higher wages were incompatible with monetary stability, necessitated price and investment controls, and prevented the most economical allocation of productive resources. Also, they encouraged the British economy to live beyond its means, and this in turn was detrimental to foreign trade and the formation of capital.

The neo-liberalists argued (1) that the currency had to be stable to avoid a price-wage spiral; (2) that it had to be stable if sufficient private savings were to materialize; (3) that the principles of the market economy excluded the use of price, investment, and exchange controls; (4) that the balance of payments problem could be solved only if the purchasing power of the currency unit remained stable; (5) that the distribution of investment funds had to rest on a rate of interest high enough to equate the demand for loanable funds with their noninflationist supply; and (6) that a "just" distribution of income is possible only under conditions of monetary stability.

Throughout the Western world there is more agreement concerning these propositions today than there was in the years directly following the war. But even now, professed support of these principles goes hand in hand with an expression of regret that perfect monetary stability is not possible.

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14 For an excellent discussion of these points, see Henry C. Wallich, *Mainsprings of the German Revival* (New Haven, Conn.: Yale University Press, 1955).

15 Ludwig Erhard, *Wohlstand für Alle* (Düsseldorf: Econ-Verlag, 1957), p. 15.

The most common reason cited is the upward pressure on prices which is constantly exerted by powerful groups and which central banks can block only at the price of unemployment.

How did the social market economy solve this crucial problem?

Labor's Contribution

West Germany's economy after 1948 was not a full-employment economy Such an achievement could not have been expected of a country which, within a few years, increased its population by 25 per cent through the influx of refugees If we consider this influx, we can realize that the social market economy performed astonishingly well in creating employment Nevertheless, it was difficult for the Adenauer administration to defend a conservative monetary policy in the face of unemployment The generally accepted recipe for full employment demanded monetary expansion However, monetary expansion at this time would have endangered monetary stability without appreciably increasing employment Credit expansion is a proper policy when unemployment is caused by a deficiency in aggregate demand If, on the other hand, the cause of unemployment is structural, an increasing monetary demand may exhaust itself in price inflation without putting many men back to work In West Germany, unemployment was structural Not all the refugees could be drawn into production by mere monetary expansion Some were unemployable, others lacked the needed industrial skills, while still others could not be moved because of the existing housing shortage Under these conditions it was much better not to endanger the whole experiment through price inflation The medicine appropriate for curing the disease of oversaving in the thirties would have been poison for an economy which needed more savings to finance an abundance of investment opportunities

But how could a conservative monetary policy be followed in an economy in which labor was permitted to bargain freely for higher wages? The answer is that German labor unions and particularly their top organization, the German Federation of Labor Unions, behaved with great wisdom and restraint This restraint in wage demands permitted the continuation of monetary stability, which was in turn the basis for the accumulation of savings needed to finance rapidly increasing investments in a noninflationary way In addition, relatively low wages made German exports competitive

Labor's wisdom and restraint can be understood when we contemplate the following facts All Germans were inflation-conscious At high cost they had learned that neither open nor repressed inflation is beneficial in the long run To this we may add that organized labor had a very real interest in the new market economy First of all, the standard of living improved materially and visibly, demonstrating that the size of the cake may

be even more important than its distribution. And secondly, labor, too, had had enough of controls. Characteristically, the labor unions had been the first organizations dissolved under Hitler. The labor union is a creature of the market and ceases to exist when the market becomes extinct. Therefore labor was willing to support a policy which was determined to prevent inflation, to raise productivity, and to preserve the market.

These reasons were more important in explaining labor's contribution to monetary stability than was the pressure which refugees exerted on the labor market.

Monopolies, Pressure Groups, and Social Security

The neo-liberalists' attitude toward monopolies is negative. The social market economy, they argue, should not permit the freedom to exclude competition, though it might tolerate a few exemptions and modifications (such as condition cartels, export cartels, or rationalization cartels). They consider the situation dangerous when businessmen tend to move from individual to collective "responsibility," believe that they have a right to cover their costs, or think that they can determine prices better than the market can. Ludwig Erhard feels that economic success (wherever it originates), results from rationalization, and improvements in labor productivity must all be made to lead to improved consumption.[16] For this reason he is against not only cartels but any pressure group asking for special privileges. He says,

> The rejection of requests by special groups is based on my conviction that, from an economic as well as from a political viewpoint, it is not possible for the state to hand out benefits and graces according to a point system, here a little more and there a little less. . . . Where are the yardsticks on the basis of which somebody could say . . . this group or profession should be preferred by the state in this respect for—yes, indeed, for which reason? [17]

Obviously, the neo-liberalists are unwilling to promise job and income security to any economic group, for such a guarantee would violate the very idea of the market economy. But this need not exclude social security for the aged, the ill, and the unemployed. Nevertheless, for two reasons the social market economy will not be eager to develop a comprehensive cradle-to-the-grave social security program. First, when driven too far, such a system will begin to interfere with the proper working of the market mechanism by paralyzing private initiative and by shifting too much re-

[16] *Ibid.*, p. 174.
[17] *Ibid.*, p. 145.

sponsibility from the individual to the state Secondly, it may lead to greater collective consumption than is compatible with a high rate of national economic growth

The neo-liberalists deny that they are less social minded than the adherents of a system of direct controls They point out that by emphasizing productivity rather than increasing equality, the social market economy will lead to a higher standard of living for all, even though income differentials will be greater In addition, they remind us that a stable value of money eliminates the injustices of price inflation with which even price controls might not be able to cope

It should be said once more that the two case studies of this chapter do not deal with decisive differences in institutions or aims but rather with different methods and emphases Chapter 24 will investigate the attitudes and problems which influence the market economies in their search for a compromise between the freedoms on which they are based and the controls which become necessary because market forces alone do not guarantee fulfillment of the aims of a welfare state

First, however, we must discuss an even more difficult compromise—that between the operation of market forces and planning for economic development in underdeveloped countries

CHAPTER 22

ECONOMIC SYSTEMS AND UNDERDEVELOPED COUNTRIES

Introduction

W. Arthur Lewis remarks in his essay *The Principles of Economic Planning* that "planning is at the same time much more necessary and much more difficult in backward than in advanced countries." [1] The present chapter can be considered a commentary on Lewis' statement. It does not deal with economic development in general, nor is it concerned with totalitarian planning in underdeveloped countries; it presupposes the absence of an all-inclusive central plan but also assumes that a well-functioning market economy does not yet exist; and it is trying to find out how economic growth can be fostered in underdeveloped countries by a "mixed" system which seeks to use both planning and market forces.

It is understandable if underdeveloped countries do not want to use an all-inclusive plan or a capitalist market economy. An all-inclusive plan is rejected because it implies a totalitarian system like the Chinese one. Market forces, on the other hand, have not made a very impressive past showing, for if they had, these countries would now be developed to the extent that they had the necessary "potential" to begin with.

Thus the predilection for a mixed system which affords the advantages of resolute government action, promises to overcome the difficulties which have prevented economic growth, and yet does not involve an amount of central integration which only a totalitarian system could handle.

However, we have already seen that mixed systems have their disadvantages and dangers. They lack the uniform and consistent allocation and distribution process inherent in either a market economy or a centrally

[1] W. Arthur Lewis, *The Principles of Economic Planning* (Washington, D.C.: Public Affairs Press, 1951), p. 121.

rather late; the process of growth being in this regard a harsh one, far removed from the welfare-state ideas of today.

Because this process of development was not centrally or even consciously planned, it needed personalities with the drive and power to maintain what Joseph A. Schumpeter called the process of "creative destruction." [2] These persons were the so-called entrepreneurs—business adventurers who dared to break new paths, introduce new techniques, and venture into unknown territory. Whether they did so for profit, power, or other motives, they were the dynamic force in the process of growth. They were sometimes inventors and always innovators. Although they may never have been very numerous, their pathbreaking work was followed up by able businessmen who saw to it that the ideas of these revolutionary entrepreneurs were reduced to more regular economic behavior in a competitive process. Without either type of person, economic development would not have materialized. But entrepreneurs and businessmen, in order to thrive, needed the right climate, i.e., a market economy without too many restrictions, a reasonably developed money and credit system, and a sufficient amount of competition.

In this pattern of growth, all contributing factors stimulated one another. Profits allowed savings; savings were readily invested; investments created employment; employment created income and expanding markets; expanding markets led to greater profits; and profits to further saving and investment.

Let us now look at today's underdeveloped countries (or, for that matter, underdeveloped sectors of developed countries). It is [illegible] see why they did *not* develop. Often the absence of only one of [illegible] mentioned factors was enough to paralyze the others.[3] Where n[illegible] sources are exceedingly poor, no growth can take place; where pc[illegible] but eliminates net saving, poverty will continue; where entreprene[illegible] absent, no use is made of existing potentialities; where weak gov[illegible] cannot provide needed public services, private investment often cann[illegible] place; where monetary incentives cannot move the factors of produ[illegible] these factors will remain where their productivity is very low or even [illegible] and where population pressure is strong, any improvement in produ[illegible] may be annulled by a population increase.

When we consider these "vicious circles," we can appreciate the [illegible] mous task faced by those who are responsible for guiding the develop[illegible] of backward countries. Whichever way they turn, they seem to be met [illegible] closed circle of interdependent limiting factors.

How can a break-through be achieved?

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[2] Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Brothers, 1942), Chap. 7.

[3] Though it ought to be remembered that the lacking factors were sometimes supplied through international trade.

planned system, they are in danger of wasting scarce resources if they cannot make definitive and consistent choices, they may be tempted to try too much with the consequence of inflation and balance of payments difficulties What we have seen to be true for relatively developed countries could be even more true for underdeveloped countries Yet these backward countries can even less afford to waste scarce resources, can even less permit themselves the amenities of the welfare state, and, being bent on planning, are even more in need of clear-cut objectives

W Arthur Lewis is correct, therefore, when he says that 'planning is at the same time much more necessary and much more difficult in backward than in advanced countries "

The Closed Circle of Limiting Factors

If we want to know why many countries did not develop while others grew without conscious effort and without governmental planning, let us enumerate the conditions whose presence facilitated development in the latter but whose absence prevented growth in the former

The relatively developed capitalist market economies owe their growth to a fortunate combination of circumstances When their growth began these countries were not overpopulated, as many underdeveloped countries are today, and the rapid increase of population was accompanied by economic growth and by an increase in per capita income Growing markets stimulated private investment, and a relatively high rate of saving thus led to a situation where, on the whole, more jobs looked for people than did people for jobs A quickly growing population found employment under increasingly favorable conditions For these countries Robert Malthus had been wrong

Per capita income in the now developed countries was probably higher before their growth got under way than income is in many underdeveloped countries today Economic development, therefore, was not stopped by the vicious circle in which poverty prevents net saving and thereby the escape from poverty through accumulation of capital goods

The savings which were forthcoming were readily invested as an upsurge in technical knowledge (the "industrial revolution") helped create an abundance of profitable investment opportunities An ever increasing output could be sold on markets whose capacity to absorb the products of mass production was constantly growing because rising investment created jobs and higher incomes for a growing population Although disproportions in the process of growth did occur, of course, nobody found it necessary to talk about ' balanced growth," for balanced growth was taken for granted Each growing industry created markets for other industries, while public utilities anticipated the needs of private business Social services came

rather late; the process of growth being in this regard a harsh one, far removed from the welfare-state ideas of today.

Because this process of development was not centrally or even consciously planned, it needed personalities with the drive and power to maintain what Joseph A. Schumpeter called the process of "creative destruction." [2] These persons were the so-called entrepreneurs—business adventurers who dared to break new paths, introduce new techniques, and venture into unknown territory. Whether they did so for profit, power, or other motives, they were the dynamic force in the process of growth. They were sometimes inventors and always innovators. Although they may never have been very numerous, their pathbreaking work was followed up by able businessmen who saw to it that the ideas of these revolutionary entrepreneurs were reduced to more regular economic behavior in a competitive process. Without either type of person, economic development would not have materialized. But entrepreneurs and businessmen, in order to thrive, needed the right climate, i.e., a market economy without too many restrictions, a reasonably developed money and credit system, and a sufficient amount of competition.

In this pattern of growth, all contributing factors stimulated one another. Profits allowed savings; savings were readily invested; investments created employment; employment created income and expanding markets; expanding markets led to greater profits; and profits to further saving and investment.

Let us now look at today's underdeveloped countries (or, for that matter, underdeveloped sectors of developed countries). It is usually easy to see why they did *not* develop. Often the absence of only one of the above-mentioned factors was enough to paralyze the others.[3] Where natural resources are exceedingly poor, no growth can take place; where poverty all but eliminates net saving, poverty will continue; where entrepreneurship is absent, no use is made of existing potentialities; where weak governments cannot provide needed public services, private investment often cannot take place; where monetary incentives cannot move the factors of production, these factors will remain where their productivity is very low or even zero; and where population pressure is strong, any improvement in productivity may be annulled by a population increase.

When we consider these "vicious circles," we can appreciate the enormous task faced by those who are responsible for guiding the development of backward countries. Whichever way they turn, they seem to be met by a closed circle of interdependent limiting factors.

How can a break-through be achieved?

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[2] Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Brothers, 1942), Chap. 7.

[3] Though it ought to be remembered that the lacking factors were sometimes supplied through international trade.

Guidelines for Development Policy

Let us define economic development as "those changes in the use of productive resources that result in a potentially continuing growth of national income per bead in a society with increasing or stable population "[4] How can these changes be accomplished in economies which up to now have not been able to use their resources efficiently?

A clarification of the policies by which economic development can be brought about is urgently needed because the mixed system which is to be used in accomplishing the task is weak and dangerous in this respect—it does not lend itself easily to a simple, clear, or even "automatic" program of action

If resources are not to be wasted on uneconomic and conflicting aims, policy for the extremely complex development effort bad best be formulated within the following guidelines

(1) An economy which is not centrally planned like the Russian economy must be a type of market economy This statement will remain true until liberal socialism can solve the problems which were discussed in Chapters 14 to 17

(2) The private or market sector of most underdeveloped economies does not work well for reasons which have been indicated It must be a function of government to help create a climate conducive to the growth of an efficient private sector Eventually, this sector should become strong enough to carry the main burden of economic development

(3) The government's task in connection with economic development can be divided into three main parts (i) It must help create necessary incentives, i e , it must foster entrepreneurship and encourage the development of a social pattern in which actions are guided to a greater degree by monetary incentives (ii) It must invest where investment is productive but not profitable, this category usually includes such basic utilities as water, power, port installations, communication, and transportation (iii) It must obtain investment funds (through taxation, domestic borrowing, foreign borrowing and credit creation) with which to finance not only functions (i) and (ii) but, possibly, some investment in the private sector as well While all these functions are performed by the governments of more developed countries, they are more urgent and more difficult of accomplishment in underdeveloped economies

(4) Emphasis on the growth of the market sector is necessitated not only by the absence of central planning, which makes market transactions and price formation in a market sector imperative Such emphasis is also

[4] Fritz Machlup Disputes, Paradoxes and Dilemmas concerning Economic Development, in *Rivista Internazionale Economiche e Commerciali* Vol IV, No 9 (Padova 1957)

necessitated by the enormity of the tasks listed under (3), compared with the government's limited resources, both human and financial. This comparison urges the advisability of entrusting to market forces and private incentives every economic activity which can be taken off the government's shoulders. W. Arthur Lewis points out that development planning "requires a strong, competent and incorrupt administration," i.e., "just what no backward country possesses;" and he suggests that "in the absence of such an administration it is often much better that governments should be *laissez-faire* than that they should pretend to plan." [5]

(5) Care must be taken to recognize theories and policies which are applicable to developed countries but which in all probability would be useless or harmful for underdeveloped economies. An example is the theory that oversaving and a shortage of investment opportunities are the main causes of unemployment, thus necessitating a policy of deficit spending to create employment. This analysis is valid even for developed economies only under special circumstances. To be guided by it in trying to cure unemployment in poor countries would be very dangerous.[6]

(6) Finally, it should be observed that

> many backward countries have adopted and are still in the process of eagerly imitating the latest policies which it took the advanced industrial countries decades or centuries to develop. The latest most up-to-date legislation on social security, regulations of labor, minimum wages, working conditions, channeling of saving through governmental agencies and impounding them for public purpose—all these policies which the developed countries have adopted only in a late stage of their development are often introduced in underdeveloped countries as soon as they are freed from colonial status.[7]

If poor countries are to set aside means of production for capital formation and economic growth, they obviously cannot afford governmental policies which imply a relatively high level of consumption. Furthermore, the governments of underdeveloped countries should carefully consider whether they could faithfully administer such policies in addition to coping with the enormous tasks which already burden them.

But how is the government of an underdeveloped country to start a process of sustained growth while staying within the above-listed guide-

[5] Lewis, *op. cit.*, p. 121.

[6] The International Bank for Reconstruction and Development offers another example. It assumed in the beginning of its operations that profitable investment opportunities abound in underdeveloped countries. But in its *Fourth Annual Report 1948-1949* the IBRD was ready to admit that "perhaps the most striking single lesson which the Bank has learned in the course of its operations is how limited is the capacity of the underdeveloped countries to absorb capital quickly for really productive purposes,"

[7] Gottfried Haberler, "Critical Observations on Some Current Notions in the Theory of Economic Development," in *Scritti in Onore di Giuseppe Ugo Papi* (Milano: 1957).

lines? It must find some way of removing the roadblocks which stand in the way of development, some policy by which an existing development "potential" can be exploited, some "initial ignition" or "pump priming" scheme on a scale grandiose enough to pull the country's economy out of a stagnation which has lasted, not for years, but for centuries

All development schemes must be connected with capital formation as an indispensable lever of economic growth Capital formation, however, poses two problems means of production must be made available for capital goods production, i e, consumption must be kept below a level which could momentarily be reached if growth did not have to be financed, and available investment funds must be invested in the most productive way We know already how a centrally planned economy of the Russian type performs these tasks We also know that central planners face difficulties in the allocation of their resources But the mixed system of an underdeveloped country will face even greater difficulties It cannot easily force the population into hard work and frugal consumption, it does not enjoy the advantages of consistent central planning, and it must strengthen the private market sector before it can delegate some of its tasks to private business

Capital Formation

W Arthur Lewis remarks that

> no nation is so poor that it could not save 12 per cent of its national income if it wanted to, poverty has never prevented nations from launching upon wars, or from wasting their substance in other ways Least of all can those nations plead poverty as an excuse for not saving, in which 40 per cent or so of the national income is squandered by the top 10 per cent of income receivers, living luxuriously on rents [8]

If Lewis is right, the governments of underdeveloped countries should be able to make a substantial amount of investment funds available, both through taxation and the inducement of private saving As far as the accumulation of investment funds through taxation is concerned, "there is nothing to prevent collective thrift from being combined with individual enterprise" [9] But it may be extremely difficult for the government of an underdeveloped country to abstain from using for public purposes all the funds which it has collected We have already seen that the demands made on the administration will be enormous when compared with available means

[8] W Arthur Lewis, *The Theory of Economic Growth* (Homewood, Ill Richard D Irwin Inc 1955), p 236

[9] Ragnar Nurkse *Problems of Capital Formation in Underdeveloped Countries* (Oxford Basil Blackwell & Mott, Ltd, 1953), p 151

As a source of investment funds, private saving fits the logic of a market economy better than does taxation. To some extent private saving can be induced by offering higher rates of interest. Much remains to be done in this respect.

> The step that governments of underdeveloped countries usually seem to be least willing to contemplate is the offer of higher rewards to savers. In many underdeveloped countries nominal rates of interest paid on savings deposits, government securities, and similar obligations are lower than rates prevailing in some of the richest countries. Often the maximum rates of interest that banks and other institutions can pay are fixed at low levels by law or regulation. When this situation is combined with a chronic tendency for prices to rise, it is not surprising that much of the community's savings is channeled into gold, foreign exchange, and residential construction.[10]

Discussions of the problem of capital formation in poor countries often refer to the existence of "disguised" unemployment in some backward economies. Indeed, labor is a factor with which a backward country may be abundantly (too abundantly!) endowed, a factor whose marginal productivity may be less than zero, and yet a factor whose surplus or marginal units could perhaps be used productively if certain conditions were fulfilled. If the unemployed in disguise could be made to produce capital goods, both capital and employment could be created simultaneously!

Economic textbooks sometimes explain capital formation as a process by which consumers' goods are made available to those who produce capital goods. This is considered the essence of saving—that men can be employed in the investment goods industry because others are willing to consume less than they are entitled to. This idea can be adapted to overpopulated but underdeveloped countries in the form of a proposal that, because a high percentage of agricultural labor is fed at zero productivity anyhow, these workers might as well be put to use in the production of capital goods.

While this proposal has some merits, it is obvious that some major obstacles must be overcome before this productive absorption of the unemployed in disguise can be achieved.

(1) After the release of this labor force without a reduction in agricultural production, the consumption of those remaining in agriculture must be kept from increasing.

(2) The released labor force must be provided with some capital goods, however primitive. The hope for capital formation thus rests on the previous existence of capital goods.

(3) There must be provision of sufficient monetary inducements for this

[10] Richard B. Goode, "Adding to the Stock of Physical and Human Capital," *American Economic Review,* XLIX (May, 1959), 151.

shift of labor, and the laborers concerned must be willing to respond to monetary incentives even to the extent of moving to the city and changing whole behavior patterns

(4) There must be some administrative or enterpreneurial initiative to organize all these changes

We *must avoid confusing* disguised *unemployment* in underdeveloped countries with mass unemployment in developed countries and formulating wrong economic policies as a result of this confusion It would be wrong to attack the problem of disguised unemployment through increasing aggregate spending or embarking on big industrial projects of high capital intensity The use of this kind of unemployed labor should be as labor intensive as is feasible, even though productivity per man employed would be relatively low What counts is not only the rise in productivity from near zero levels but also the number of laborers affected by this rise

We have seen that the social economy should solve the problem of *how* to produce, not by indiscriminately adopting the newest techniques, but by combining its factors of production according to their relative scarcities This does not mean that the relative abundance of labor in a given country excludes *technological* improvements Benjamin Higgins is only partially correct when he says that "no technological advance has as yet been *discovered which is suited to the factor proportions* of the underdeveloped countries "[11] There are many stages of technological development which have been passed (or even by passed) by the now developed countries but which might fit the special factor proportions of some poor countries However these production methods are not likely to be discovered under the influence of the "demonstration effect," i e , if poor countries try to imitate the rich in a misconceived endeavor to "industrialize" without proper guidance by relative factor prices

We have seen that interest rates which are set too low are detrimental to private saving They are even more dangerous for the other component of capital formation—investment It is most important that market rates of interest clearly indicate the scarcity of investment funds and that the government refrain from establishing priority schemes which distribute these funds contrary to the distribution which correctly chosen rates of interest would have brought about We have seen that even "rich" countries *cannot afford* the *waste of resources* resulting *from* ill-considered priority schemes Backward countries can afford this waste even less

It is true that heavy investment must be undertaken in the public sphere if the development process is to be successfully started Where a comparison of interest and profit rates is not possible in the public sphere, priorities must be used Then the danger is great that too much investment will take place in one field and too little in another, thus precluding the

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[11] Benjamin Higgins *Economic Development Principles, Problems and Policies* (New York W W Norton & Company Inc 1959), p 258

maintenance of a proper balance even within the public sector. It is also likely that the total of all public investments will leave too few funds for private investment or will overtax the productive power of the nation, with the result of inflation. Yet price inflation is damaging to a country which wants to foster the growth of domestic saving and the influx of foreign capital, Both need price stability. In addition, price inflation leads to balance of payments difficulties and exchange controls, which, in turn, are another major obstacle to foreign investment.

Private and Public Investment

If central planning is to be avoided, the government must see that private business and private initiative eventually play a major role in the process of economic growth. Herc, as is true of saving, the plight of the backward countries is sometimes overstated. Some business skill is available in all countries. It does not make sense to deny this and at the same time to assume the availability of unlimited governmental administrative skill. Also, not too much entrepreneurship (in the narrower sense) might be needed. Managerial initiative will often be limited to an adaptation of *known* techniques, skills, and methods to the conditions of underdeveloped countries.

It is nccessary to make the most of what managerial skills are available and to crcatc a climate in which those possessing such skills find it worth whilc to enter business and to dcvelop private initiative there. Where "the accepted scale of social prestige places . . . the man of business far down the line," the underdeveloped countries have

> to try to find means of elevating constructive business pursuits to a higher prestige lcvel in the social hierarchy and of diverting the experience and talents of the minority groups from commerce and trade to manufacturing and other more constructive activities. Too often, a by-product of nationalism is covert and overt reaction against such minorities, long before the dominant social groups are ready to supply entrcprcneurial talent from their own ranks.[12]

If neededd investment funds and business skills cannot be found, the government may be right in embarking on projects outside the public utilities and social overhead area. We must make sure, however, why the private sector of the economy was found wanting. It could be that private capital did not care to invest because the project is out of line with the rest of the economy's growth and therefore not profitable. Private capital cannot afford the luxury of showcase industrialization. Because it must follow the

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[12] William H. Nicholls, "Accommodating Economic Change in Underdeveloped Countries," *American Economic Review*, XLIX (May, 1959), p. 158.

guidance of prices and costs, private investment is not likely to lead to unbalanced growth As Charles P. Kindleberger rightly argues,

> Given uncertainty as to the exact nature of blocks to development, probing along a broad front in reconnaissance strength may make more sense than committing all one's forces to a single salient which may prove unyielding [13]

Public managers are not always able to apply the type of reasoning which is appropriate to the market sector of the economy Sometimes they must think in terms of priorities rather than cost-price relations And what is correct and necessary in the public sector is not necessarily conducive to successful private enterprise Furthermore, public managers may be tempted to carry the "external economies" argument, from which public enterprise derives its justification, into fields which ought to be reserved for private enterprise if we want to develop a market economy

Emphasis on external economies[14] is decisive where public investments are not profitable but are nevertheless considered productive In this category belong public education, public health, and such basic utilities as water, electric power, port installations, and transportation In all these cases we are entitled to assume that because of these investments the costs of private firms will be reduced In many cases private investments will not be possible until public investment of this type has taken place For this very reason public investment must play a strategic role in economic development, and *it is likely to be proportionally greater than in developed* countries where social overhead expenditures have not been neglected We already know that private investment cannot be expected to take care of needs whose satisfaction does not permit comparisons between rates of profit and rates of interest

However, the concept "external economies" has also been more broadly interpreted [15] It is often applied to the effects which investments by private firms have on the rest of the private sector of the economy These effects give rise to the argument that economic growth should be balanced to allow a wide range of investment processes to assist each other.

[13] Charles P Kindleberger, *Economic Development* (New York The McGraw Hill Book Company, Inc , 1958), p 155

[14] "The concept of external economies refers to a situation in which the cost curves of individual firms shift downwards because of the historical development of their environments For example, an increase in the size of an industry may attract a more efficient labor force and thereby bring benefits to all firms in the industry Or the growth of transportation facilities in a particular area may lead to a lowering of costs for firms using the services of the transportation industry The notion of external economies recognizes the interdependence and complementarity of various sectors of the economy As one part grows it stimulates other parts not only by increasing demands but also by decreasing costs"—Gerald M Meier and Robert E. Baldwin, *Economic Development Theory, History, Policy* (New York John Wiley & Sons, Inc , 1957), pp 22 23

[15] See, e g , footnote 14

It is understandable, then, that public administrators might want to embark on investments in what would normally be the private sector, even though these investments are not yet profitable. They ascribe to such investment projects important external economies. The lack of profitability seems overcompensated by the projects' beneficial effects on society as a whole. Thus the line between private and public investment areas becomes blurred. There is some danger that large public investments in what normally would be the private sector (e.g., steel mills) may, through their very size, violate the principle of balanced growth which underlies the concept of external economies.

The developing country must carefully plan its expenditures in the public utilities field and refrain from investing in industrial projects which would violate the basic requirement that consistency be maintained between all investments. Once again it must be emphasized that this consistency is normally achieved either through a comprehensive plan or through the correcting influence of market forces. It is dangerous, therefore, indiscriminately to substitute the external economies criterion for the more concrete and reliable measure of profitability.

Recent emphasis on "balanced growth" is a sign that investment criteria in underdeveloped countries have lacked consistency and clarity. It should not be necessary to point out that modern mass production of shoes cannot be profitable where the population does not have sufficient purchasing power to buy them; it should likewise be self-evident that it is necessary to consider the effects which innovations in the agricultural sector will have on the industrial sector and vice versa.[16] On the other hand, we must beware lest the request for balanced growth is turned into an argument for autarky. An industry cannot be considered overexpanded if, according to the law of comparative advantage, it can find markets for its products abroad.[17]

Conclusion

It is dangerous to make generalized remarks about underdeveloped countries because the economies bunched together under this term often differ greatly in individual features. Some of these countries do not even have the needed development potential. Fritz Machlup is right when he calls it the basic paradox in the definition of an underdeveloped economy

> that the term is not used for the economies with the greatest "development potential," but chiefly for those which would *not* be regarded as seriously underdeveloped in a world without barriers, political or otherwise, to the movements of goods, capital, and people.[18]

[16] Cf. Nurkse, *op. cit.*, p. 7; Lewis, *The Theory of Economic Growth*, pp. 276-277.
[17] Machlup, *loc. cit.* The principle of comparative advantage will be discussed in the following chapter.
[18] *Ibid.*

But even if we limit our consideration to conntries with development potential and assume that they can solve the Malthusian problem of excessive population growth, such countries still face formidable problems in their attempt to overcome the stalemate of poverty Mere reference to the example set by developed countries does not suffice To get development started, to get ' over the hump," the government must make a conscious and determined effort The purpose of government development planning is to force that economic growth which did not occur naturally—just as plants can be forced hy artificial means to mature at a faster rate Thus, in the heginning, at least, the government must play a leading role But we should not forget that administrative ahility is perhaps just as scarce as entrepreneurship in hackward countries To suggest that the government do everything would be entirely wrong On the cootrary, the government must he prevented from overtaxing its limited resources and capabilities Emphasis must he at least as much on what the governmeot should *not* do as on what it ought to do

The role of government in the process of economic development can be reduced to manageable proportions if we give up "the profouod distrust of the judgment of the individual producers and consumers"[19] which is characteristic of many who are concerned with development questioos This is the underdeveloped couotry version of the very same distrust which we found to have been unjustified in the developed economies after World War II We saw how West Germany successfully revived her ecooomy through a consistent return to the principles of the market when the geoeral trend of ecooomic thinking would have suggested the maintenance of strict coorols We must hasten to add, however, that the developmeot of a hackward country is not the same as the revival of an advanced economy which has been temporarily disorganized

Nevertheless, the parallel lies in the fact that in both cases there has heen a tendency not to trust the market but to trust, instead, the wisdom of governments If this attitude were carried to the logical conclusion of instituting a centrally planned totalitarian economy, it might make sense in terms of economic growth—at the expense of ecooomic freedom Indeed, it may be far easier to *force* the population to change its behavior patterns than to *induce* a similar change under the conditions of a market economy But if we reject the totalitarian solution, economic development must then depend on successful creation of the framework of a market economy economic initiative, sufficient mohility of lahor in response to monetary incentives, an adequate supply of social overhead services, and, finally, sufficient capital formation

[19] Haberler, *loc cit*

CHAPTER 23

ECONOMIC SYSTEMS AND INTERNATIONAL TRADE

The Advantages of International Trade

The countries of the world are not equally endowed with productive resources. Some enjoy a favorable proportionality of skilled labor, capital, and natural resources; others abound in cheap labor but are poor in capital; while still others combine a scarce labor supply with rich natural resources. These various factor proportionalities lead in market economies to different patterns of factor prices and, accordingly, to different patterns of product prices. If the structure of commodity prices in country *A* differs from the price structure in country *B*, both countries will gain from international trade.[1] Each country can specialize in the production of commodities suggested by its characteristic relative advantage in factor endowment, and each country will gain when its exports (with which it pays for its imports) cost less to produce than it would have cost to manufacture the imported goods at home (assuming that this production had been at all feasible). Clearly, this principle is so broadly stated that it applies whether we deal with market economies or with planned economies. This theory of comparative advantage also shows that backward countries can participate in international trade even though they may be less efficient than the more advanced economies in every line of production.

The residents of a country will import products which, in spite of the cost of transferring them from one country to another, are still more attractively priced than home-produced goods; and they will pay for these imports by exporting commodities which are competitive in foreign markets. To translate domestic into foreign prices we need exchange rates. Once we know that we can buy or sell one pound sterling for $2.80, we can

[1] See Appendix, p. 326, and footnote 4.

directly compare American and British prices. When we know, in addition, the cost of transferring commodities from one country to the other (freight, insurance, duties), we can determine which goods will be imported and exported.

Because in the long run a country's exports must pay for its imports, we need an adjustment mechanism which integrates the different countries' price systems and balances international payments. We can, e.g., permit the exchange rate to fluctuate. If a country has imported more than it can pay for by exports, the value of its currency unit will fall in terms of other countries' currencies, and its products will instantly become cheaper for these other countries. If, on the other hand, the rate of exchange is to remain stable, as under the old pre-1914 gold standard system, an excess of imports over exports will require a downward adjustment of prices in the country experiencing such an excess.

Obviously, a relatively backward country will not be able to trade with a relatively more advanced country on the basis of equal gold wages. The less efficient a country's production, the lower its wages must be to permit sufficiently large exports. Nevertheless, both backward and advanced countries gain if it would cost more to produce their imports at home than to produce exports which pay *for these imports*.

After World War II it was often said that the then existing "dollar shortage" was caused by the United States' superiority as a producer and that the dollar shortage could never be overcome because the discrepancy in productivity was constantly growing. We know now that this fear was unfounded and that the dollar shortage came to an end as soon as a better integration of the price systems and monetary policies of the different market economies was achieved.

The classical economists were free traders, they believed in the advantages of international division of labor and considered it foolish to reduce the advantages of specialization through the creation of artificial transfer costs such as duties. But businessmen who were meeting stiff foreign competition did not subscribe to the free trade philosophy. On the contrary, these protectionists tried to identify their own private interests with those of the nation. They argued that a policy of protection would increase employment, keep money at home, expand domestic markets, keep out the products of cheap labor, etc. These arguments always broke off too soon. The protectionists refused to see that inefficient protected industries would grow at the expense of efficient export industries and that money spent on imports would eventually come back as demand for the products of the country's export industries.

Thus the capitalist economy presented the strange picture of sound theory but often unsound practice in matters of international trade policy. Protectionism did not agree with the philosophy of capitalism, which rests on the assumption of competition (including foreign competition) and be-

lieves in the most elaborate international division of labor. That capitalism fell victim to protectionism was mainly due to the fact that special interests demanding protection were far more aggressive than the large but unorganized group which had to suffer—the consumers.

However, even classical economics acknowledged a special case where protection might be permissible. An "infant industry" could be allowed to grow to maturity before being exposed to the sharp wind of competition from more advanced countries. While theoretically sound, this argument often led to permanent protection of firms which had been established under the cover of protection but which were never able to achieve a competitive status. The original idea, of course, was that an infant-industry tariff should be only a temporary affair.

Insulation against Depression

The classical theory of international trade, as indeed the classical theory in general, proceeded on the assumption of "full" employment in the trading countries. Admission of the possibility of mass unemployment, however, led to substantial changes in the theory of international trade and in commercial policy. It could now be shown that changes in the national income of one country will affect other countries, that fluctuations in economic activity are transmitted from country to country, and that in the process of transmission the balance of payments will be temporarily disturbed.

If it is possible for a country's employment and income level to be adversely affected by another country's depression, a case can be made against free international trade. It can now be argued that what a country gains through international division of labor it can lose through unemployment and that protectionist measures are therefore justifiable in connection with domestic full employment policies.

This reasoning is wrong, however, if it means to say that foreign products are to be excluded whenever unemployment occurs in an industry exposed to foreign competition. We must always consider the effect of protection on the protectionist country's export industries. Furthermore, such protectionist measures would be beggar-my-neighbor policies; i.e., they would create unemployment in the rest of the world.

But how is a country which wants to maintain a high employment level to defend its economy against the contagious effect of depressions in other countries? Let us assume that a falling-off of country *A's* economic activity causes country *B's* exports to fall. As investment and employment decline in *B's* export industries the whole of *B's* economy will suffer, for a negative multiplier effect now lowers *B's* national income in the wake of country *A's* depression. With falling national income, country *B's* imports will decline; but because *B's* imports are not likely to fall as fast as its exports,

B will experience a balance of payments deficit If country *B* tries to boost its exports and lower its imports by contractionist monetary policies, it aggravates the process of domestic depression it can achieve balance of payments equilibrium, but only at the cost of a further increase in unemployment If country *B* tries to counteract domestically the contraction which was generated by a decline in its exports to country *A*, i e, if it embarks on expansionist monetary and fiscal policies, its balance of payments deficit increases

In this dilemma country *B* may decide to insulate its economy against contagious foreign depressions through import quotas and exchange controls Domestic full employment may then be achieved at the price of a substantial shrinkage of international trade

In Chapter 9 we saw that a capitalist market economy can counteract contractionist tendencies in its private sector through monetary and fiscal policies These policies were partially successful after World War II Postwar experiences, however, have not quite dispelled the fears of those who suffered under the impact of the United States depression in the early thirties In the first three years of that depression, foreign dollar earnings fell by 68 per cent, necessitating drastic changes in the domestic and foreign economic policies of many countries which were trading with the United States [2] This instability of the biggest capitalist country forcefully impressed itself upon the rest of the world We can well understand that the events of those years led other countries to feel that it is dangerous to trade with a capitalist country whose sheer size makes it important in international trade but whose domestic economy is subject to violent cyclical changes and whose imports have the additional aggravating feature of falling relatively faster than its national income

In order to adjust their economies to this new and dangerous situation, the other countries used drastic measures to increase their exports and to decrease their imports These were the years when domestic deflation, exchange control, and import quotas were used by one set of countries, while another set hoped to gain more through competitive exchange depreciation As defensive measures these policies were understandable [3] Nevertheless, most of them were incompatible with nondiscriminatory multilateral trade

Multilateral trade permits a country *A* to pay for its imports from country *B* by exports to country *C*, all currencies being freely interchangeable Multilateral trade maintains the principle of buying and selling in the most

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[2] Cf *The United States in the World Economy* U.S Department of Commerce, Economic Series, No 23 (Washington, D C United States Government Printing Office 1943), pp 5 6

[3] But it is not possible to excuse the protectionist policies of the United States Import duties were raised in 1930 when the balance of payments deficit of the other countries was already excessive In addition the dollar was devalued in 1934 in hope that domestic prices would rise Thus the United States did without compelling reason what other countries did under the impact of a foreign exchange crisis

favorable markets; i.e., it does not reduce international trade to barter in form of bilateral deals. Multilateral trade implies nondiscrimination. Even where tariff duties are imposed, nondiscrimination can be maintained through unconditional use of the most-favored-nation clause, the mutual promise that the other country will not be treated worse than any third country. Tariffs can be prohibitive, of course; but where they are nonprohibitive and where they are applied in a nondiscriminatory manner, they maintain the principle of international division of labor according to the working of the price mechanism in the different countries. While imposing, as it were, artificial transportation costs, the tariff still leaves the allocation of productive resources at least in part to economic forces. But it is indeed *because* the tariff still permits a relatively close interrelation of the trading economies' price systems that the tariff—unless prohibitive—is not considered sufficient when countries try to insulate themselves against foreign depression. More powerful protectionist instruments are needed, instruments which purposely disrupt the interrelaton of the price systems of different market economies. In the case of import quotas and exchange controls the government arbitrarily determines what is to be imported, how much, by whom, and from which countries. Imports become largely independent of market forces. This is the very reason why countries which want to insulate their economies turn to these controls. Only direct controls give these countries sufficient assurance that international economic relations will not disturb the domestic scene.

But while direct quantitative controls may provide the desired insulation, it is practically impossible to handle these controls in a nondiscriminatory manner.

> Quantitative restrictions make it virtually impossible to prevent discrimination between countries. The most-favored-nation clause is practically inapplicable to quotas and quantitative restrictions in general. For there is no accepted or plausible principle of quota allocation which could be called non-discriminatory and consistent with the most-favored-nation principle. Various systems of quota allocation have been proposed as non-discriminatory but none is satisfactory. Equal quotas for all countries of supply are clearly inequitable. Allocation in proportion to imports from different countries in some base year is unsatisfactory and unjust in the case of crops which fluctuate from year to year. In the case of industrial products too it is liable to get more and more out of date, as the underlying situation changes.[4]

In case of exchange control the supply of foreign exchange may be allocated uniformly on a percentage basis, but as in the case of quotas this freezes the pattern of trade that existed in the base period.

[4] League of Nations, *Quantitative Trade Controls, Their Causes and Nature* (Geneva: 1943), pp. 25-26.

We need not assume that all countries which apply direct controls to their international trade are planned economies They may be capitalist market economies which only want to defend their employment level and their foreign exchange reserves against the impact of foreign economic fluctuations But we cannot overlook the fact that these direct controls are alien to the capitalist philosophy Indeed, it is quite possible that a growing use of quotas and exchange controls may eventually lead to numerous domestic controls For this reason the devotee of capitalism cannot argue consistently for the more advanced practices of protectionism without renouncing the basic philosophy on which his economic system is built [5]

How, then, can a compromise be found between a country s legitimate desire to protect its economy against the contagious effect of foreign depressions and its desire to participate in nondiscriminatory multilateral trade?

The problem could be eliminated if the trading countries succeeded in reducing economic fluctuations to manageable proportions without using beggar my neighbor policies Fortunately, domestic monetary and fiscal policies aiming at high employment are quite compatible with multilateral trade What maintains a high level of domestic economic activity helps other countries to maintain exports Furthermore, any aid extended by the depression country to others in the form of international lending helps to stimulate investment in the depression country s export industry and helps other countries to overcome an acute shortage of foreign exchange

We must also remember that balance of payments difficulties can be due to causes other than foreign depression We saw in Chapter 21 how a country can perpetuate balance of payments disequilibrium through domestic inflation If such a country is not willing to live within its means it will be tempted to use quantitative controls in its international trade relations, just as it will try to repress inflation at home through price controls Obviously, therefore, maintenance of nondiscriminatory multilateral trade requires that undue domestic inflation be avoided, i e, inflation worse than in other countries

We cannot hope to achieve perfect integration of the trading countries' domestic economic policies at high employment levels and stable prices *But perfect integration is unnecessary because we can rely to some extent* on exchange rate adjustments It would suffice if discrepancies between different countries' domestic economic policies were kept within a range which would allow their correction without restort to quantitative controls In no case should quantitative restrictions exceed those necessary to forestall an imminent threat to a country's foreign exchange reserves Such restrictions should be removed when conditions no longer justify their use

[5] Cf Lionel Robbins *Economic Planning and International Order* (London Macmillan & Co Ltd, 1937), pp 24-26

While in force, the administration of quantitative restrictions should be as nondiscriminatory as possible.[6]

Domestic Planning and International Trade

Liberal socialist writers admit the advantages of international trade and suggest that fullest use be made of these adavantages.[7] It may even be said that those who advocate a planned economy have sometimes shown a clearer conception of the advantages of international trade than have many businessmen in capitalist market economies. Because the socialist writer assumes full employment when discussing trade between socialist economies, fear of unemployment does not dilute his willingness to have labor employed where it is most productive. Socialist planners look at imports as a valuable addition to the national product and regard exports as the price which must be paid for these imports. In capitalism, however, we are sometimes told that exports are "favorable" and employment-creating, while imports are "unfavorable" or unemployment-creating.

How is multilateral, nondiscriminatory trade to take place among liberal socialist economies?

H. D. Dickinson simply assumes that the supreme economic council would compute domestic prices, compare them with foreign prices on the basis of a given exchange rate, and determine, accordingly, which commodities should be imported and which exported.[8] Similarly, R. L. Hall suggests that "a list of products may be drawn up in order of advantage, those with the greatest comparative advantage at the top and those with the least at the bottom" and that international trade equilibrium will be established through the rate of exchange at which exports pay for imports.[9]

Dickinson admits that state trading by large national monopolies leads to bilateral monopoly "in which it is probable that there is no determinate stable position of equilibrium, but in which either party has an incentive to get the better of the other by the use of fraud and of force." [10] This remark suggests that the instability of prices could be greater under state trading than under competitive private trading on a broad multilateral basis.

Liberal socialist writers are, of course, inclined to make light of this

[6] Cf. General Agreement on Tariffs and Trade, *Basic Instruments and Selected Documents*, Vol. III, *Text of the General Agreement* 1958 (Geneva: November 1958), Articles XII and XIII.

[7] See, for example, R. L. Hall, *The Economic System in a Socialist State* (London: Macmillan & Co. Ltd., 1937), Chap. 12; H. D. Dickinson, *Economics of Socialism* (New York: Oxford University Press, 1939), Chap. 7. Both Hall and Dickinson emphasize the classical theory of comparative advantage.

[8] Dickinson, *op. cit.*, p. 174.

[9] Hall, *op. cit.*, pp. 220 ff.

[10] Dickinson, *op. cit.*, p. 177.

monopoly problem They point out that government monopolists would refuse to use their power to the detriment of the consumer or other countries and that "within the 'glass walls' of socialist economy it would be difficult to maintain unreasonable discrimination for long " [11]

There are several possibilities, however, which we must consider

We have already seen that it is not at all obvious that the "glass walls" of the liberal socialist economy will clearly reveal the cost and price structures of the different nationalized industries [12] The pricing problem of the socialist economy is, as yet, far from satisfactorily solved Similarly, we had to conclude that the mere existence of socialism will not eliminate the dangers of monopoly [13] The monopolistic concentration of power is, by definition, much greater in socialism than in capitalism The liberal socialist argument rests on the rather weak assumption that public managers will play at competition while they are, at the same time, responsible to the central planning board

Even if we assume that the managers will behave at home "as if" they were acting competitively, it is not obvious that they would act in a nondiscriminatory fashion in their relations with other countries Instead, it must be assumed that they will use state trading to overcome some of the many difficulties that are sure to develop in the execution of the national plan In addition, there is no reason to take for granted that the wealthier socialist communities will be eager to share their wealth with the poorer And from this attitude it is only a small step to the desire to make full use of the bargaining powers inherent in state trading

In commercial relations between state trading boards and private commercial firms of capitalist countries, the state trading boards are often at an advantage, for many private sellers are confronted by one buyer, or many private buyers by one seller To protect the interests of its citizens the capitalist country may feel compelled to create state trading agencies, thereby violating the basic principles of its own economic system and creating a conflict between its domestic antimonopolistic and its foreign commercial policies

Assuming that state trading agencies promise to adhere strictly to the principles of nondiscriminatory multilateral trade, we are still faced with grave technical difficulties, and these will become major problems if we are not absolutely sure that we can implicitly trust the promises of the state trading country

In the case of a centrally planned economy of the Russian type, state trading will become even less reconcilable to the principles of nondiscriminatory multilateral trade The foreign trade monopoly now becomes an *instrument for insulating the central plan against disturbance from the*

[11] *Ibid*

[12] See Chapter 16, above

[13] See Chapter 17, above

outside. The advantages of international trade may be sacrificed for the advantages of planning. Nevertheless, imports and exports may still be considered advantageous, particularly if they can be used for corrections of planning errors.[14] The possibility of using foreign transactions as a balancing item in domestic planning would be enhanced if foreign credits made it unnecessary to equate imports and exports within short periods.

As seen by the trading partners of a centrally planned economy, the latter's imports and exports can thus become entirely erratic and can cause dangerous price fluctuations. This effect need not be the result of a desire to disturb world markets. It could simply be the consequence of the different role which foreign trade plays in a centrally planned economy, where exports and imports would be determined not only by comparative advantage but also by the requirements of the central plan.

While prices are to play the same role in capitalist and liberal socialist economies, they would perform no decisive guiding function in a centrally planned economy. The latter, therefore, may find it advantageous to pay high prices for imports and to accept even excessively low prices for exports if the success of the plan should demand this sacrifice. Furthermore, we have seen that the "price system" of a centrally planned economy will make it difficult to establish costs and prices comparable to those of market economies.

When centrally planned economies trade with one another, the abovementioned difficulties need not occur, for the integration of their respective plans will include their mutual trade relations. It is to be assumed that the planned division of labor tries to follow the basic principles of comparative advantage, at least to the extent permitted by the rudimentary cost accounting of the totalitarian system.

It is also possible to envisage trade among centrally planned economies which rests on the principle of discrimination and monopolistic exploitation. Where a "master" country is far more powerful than its "satellites," international trade can be planned to benefit the master country more than the satellites.

Both liberal and authoritarian socialism must use state trading because private trading is incompatible with government ownership of the material means of production. These systems have excluded trade between private firms as part of their general bar against private enterprise. However, state trading can also be used by countries whose economies are not planned but whose governments determine "what goods will be bought, in what amounts, from what suppliers, and on what prices and terms." [15] The reasons for state trading may be exactly the same as the reasons which led to

[14] Cf. Adolf Weber, *Sowjetwirtschaft und Weltwirtschaft* (Berlin: Duncker und Humblot, 1959), p. 231.

[15] Harry C. Hawkins, *Commercial Treaties and Agreements, Principles and Practice* (New York: Holt, Rinehart and Winston, Inc., 1951), p. 199.

the use of quantitative controls State trading simply supersedes import quotas and exchange restrictions and is, accordingly, exposed to most of the objections which have been made against quantitative controls in international trade

Is a Compromise Possible?

The Havana Charter for an International Trade Organization[16] which remains an important document in spite of its withdrawal from legislative consideration, wants to make state trading compatible with nondiscrimination and multilateralism For this purpose it uses a "commercial considerations" formula Art 29 specifies that state trading enterprises shall make purchases and sales "solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation and other conditions of purchase or sale, and shall afford the enterprises of other Member countries adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sales " Theoretically speaking, state trading agencies might try to act in this non discriminatory fashion to gain the greatest possible advantage from international trade Practically speaking, however, it must be doubted that state trading agencies will be permitted to behave like unregimented private traders When state trading is part of a central plan, it is not at all obvious that the aim of the plan will coincide with commercial considerations, which are influenced by world market conditions In other words, it is improbable that state trading agencies will adhere strictly to commercial behavior if state trading is entrusted, as it undoubtedly will be, with the job of insulating the planned economy—or at least its full employment policies—against contagious foreign depressions An "as if" behavior is not a very reliable practical guide

> It is too much to expect that the right hand of the purchasing agency will completely ignore the left hand of the exporting agency There will inevitably be a tendency for state-trading enterprises to enter into bilateral arrangements, either explicit or implied, with other state-trading nations or even with countries in which foreign trading is in private hands [17]

The commercial considerations approach is inadequate even on its own terms, for it implies that the state trading agency will act as though it were

[16] *Havana Charter for an International Trade Organization* (U S Department of State Publication 3206, Commercial Policy Series 114, Washington, D C, March 24, 1948)

[17] Raymond F Mikesell "Quantitative and Exchange Restrictions under the ITO Charter," *American Economic Review*, XXXVII (June, 1947), p 366

buying and selling competitively, while actually the agency has monopolistic and monopsonistic powers. If, however, a monopolist *does* act according to commercial considerations alone, he will often use discrimination as a means of increasing his profit.

The General Agreement on Tariffs and Trade (GATT)[18] follows. in Art. XVII, the exact wording of the commercial considerations formula of the ITO Charter. However, it does not show how this formula can be applied in planned economics.

The perplexity of the question of how nondiscriminatory trade and economic planning can be combined is reflected in the following statement by the chairman of the Contracting Parties of the GATT of June 2, 1959.

> The association of Yugoslavia and Poland's request for accession obviously raise serious problems for the CONTRACTING PARTIES. In the past, the requests for accession which we have received have always been from countries whose economic structure and commercial policy system did not differ greatly from those existing in our own countries. In the case of Yugoslavia, we considered for the first time the possibility of applying the principles of the General Agreement to a country whose economy differs in many important respects from that of our countries. The divergence of economic concepts seems still greater in the case of Poland, and in the near future the CONTRACTING PARTIES will probably have to give serious consideration to the possibility of broadening our philosophy and making our system more flexible so as to enable countries whose economy is based on free enterprise to co-operate fruitfully within this organization with those whose economy is entirely planned. It is too early to predict what solutions we can arrive at in the future and submit to our governments in order to achieve that result, but it is not too early to point out to our governments that this is a problem to which they will have to give careful consideration in coming months.[19]

Obviously, nobody yet knows how a satisfactory compromise can be achieved between the different basic principles which underlie international transactions by market and those which underlie international transactions by centrally planned economies.

That nondiscriminatory multilateral trade can be carried on between market economies and centrally planned economies is questionable for several reasons.

(1) All state trading is exposed to those difficulties which make import

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[18] General Agreement of Tariffs and Trade, *Basic Instruments and Selected Documents*, Vol. III, *Text of the General Agreement 1958* (Geneva: November, 1958).

[19] Information Service, European Office of the United Nations, Geneva, Press Release GATT/454, 2 June 1959.

quotas and exchange controls basically incompatible with ooodiscrimination If a state trading country promises to apportioo its foreign purchases oo the basis of some representative period, it freezes a previous pattern of trade and does not allow for changes in the competitive situation, if it promises another country to purchase goods for not less than an agreed minimum amount, it might, in keeping its promise, actually discriminate against other countries if its total purchases from all countries fall off

(2) The centrally planned ecooomy does not have a price system of the kind which is oeeded if trade is to be based oo the priociple of comparative advantage and if conformity to this principle is to be checked by its trade partners

(3) The centrally planned ecooomy would experience difficulties io adjusting its plao to changes occurring in the rest of the world These changes are unlikely to be permitted to alter the plan once it has been formulated On the cootrary, we must assume that central planners will use foreign trade transactions to iron out bottlenecks and to get rid of surpluses—to enhance the plan's balance at the cost of greater instability for the rest of the world

It remains to be seen wbat concessions could be made by an authoritarian ecooomy even while the plan is still in its formative stage A centrally planned system could perhaps agree on fixed amounts of exports and im ports at fixed prices, both with regard to the rest of the world as a whole and to individual countries However, oondiscrimination, avoidance of monopolistic prieing, comparative cost accounting, and the choice of base periods would still pose grave problems Trading between individual firms of different market economies rests on commercial considerations Trading between centrally planned economies rests on the requiremeots of their integrated plans Trading between centrally planned economies aod individual traders in market economies necessitates changes in basic principles for both systems, and the exteot of the changes required may exceed the possibility of a compromise

However, the great advantages of international division of labor may oevertheless lead, in times of peaceful coexistence, to a compromise These advantages will induce the market economies to be satisfied with a system which falls short of multilateralism and will impel the centrally planned economies to use trading methods which are acceptable to the free world International trade under compromised principles will prove to be preferable to no trade at all

CHAPTER 24

THE AGENDA OF GOVERNMENT IN A MARKET ECONOMY

Consumption- and Production-Oriented Systems

As indicated at the beginning of our study, comparative analysis should enable us to better determine whether various proposed economic policies are compatible with the continued existence of a country's basic economic system. In the preceding three chapters we have examined situations involving a collision between different basic economic philosophies. In this last chapter, we shall examine more closely two attitudes which have continued to vie with each other in the market economies of the developed countries of the West ever since the economic crisis of the 1930's. Our comparative analysis of economic systems should have prepared us to better evaluate the significance of these attitudes.

If we leave aside the centrally planned systems and the special problems of underdeveloped countries, we are left with market economies which have in common that they are not centrally planned and are, in the main, based on private property of the material means of production. For the time being, at least, nationalization has lost its appeal. It is imperative, therefore, that economic policies in the developed countries of the West be compatible with the market mechanism on which the economic life of these countries is based.

But acceptance of private property and of a market system does not mean laissez faire. We saw that the market economy needs to be "corrected" for several reasons. Outstanding among the aims which can be reached only through government interventions are greater income equality, social security, maintenance of a sufficient degree of competition, monetary stability, maintenance of reasonably high employment levels, and nondiscriminatory multilateral trade.

Within the market economies of the West there exist differences in economic philosophy which must be compromised Fortunately, these differences are not opposites but differences of emphasis or approach We have already seen how different philosophies guided the welfare policies of the British Labor party after World War II and the neo-liberalists in West Germany after 1948 These philosophies have been characterized, respectively, as consumption oriented and production-oriented [1] In the consumption-oriented economy the emphasis is on high employment, aggregate demand, and social security, in the production-oriented economy, on initiative, capital formation, and monetary stability The consumption-oriented system is especially conscious of the fact that aggregate demand may be insufficient for the maintenance of a high employment level, the production oriented system urges monetary stability as the precondition of a well-functioning market economy But the consumption-oriented system Is in danger of trying to cure all economic evils through changes in aggregate demand, and the production-oriented system runs the risk of overemphasizing the resilience of the market mechanism and the efficacy of monetary policy

Unfortunately, the representatives of the consumption-oriented school have all become identified as ' Keynesians " We shall see that Keynes' ideas have little in common with welfare economics and nothing at all with socialism Keynes' theories, for instance, cannot be held responsible for the direct controls which in the years after World War II interfered with the functioning of the market economies

These interferences induced neo-liberalists to warn the Western world that unless a greater understanding of the market mechanism is achieved the solution of our economic problems may have to be sought in totalitarian controls

The neo-liberalists, however, are in danger of putting too much faith in the market economy in the face of political forces which tend to overtax the resilience of the price mechanism The consequences could be just as grave as those of a welfare economy which tries to achieve its aims by means of uncoordinated direct controls

What welfare aims are compatible with the principles of the market economy and what methods should be used to achieve these aims? Such are the most important economic questions which have to be answered by the Western world

The following pages cannot attempt an answer But we can follow the ideas of two great exponents of the market economy whose approaches are to some extent characteristic of the aforementioned difference in emphasis F A Hayek and Lord Keynes

[1] See Henry C Wallich, *Mainsprings of German Revival* (New Haven, Conn. Yale University Press, 1955), Chap 2

Road to Serfdom?

Considerable discussion concerning the dangers of government controls in market economies has centered around Friedrich A. Hayek's stimulating book *The Road to Serfdom*.[2] This book has been highly praised in conservative circles and severely attacked by indignant liberals and socialists who resented Hayek's implication that his eloquent criticism of nazism applies equally to all forms of collectivism and therefore also to liberal socialism.

In presenting Hayek's main theses, we limit the argument as much as possible to economic problems.

Hayek contends that "the rise of fascism and naziism was not a reaction against the socialist trends of the preceding period but a necessary outcome of those tendencies" (pp. 3-4).[3] Since "the people whose views influence developments . . . are now in the democracies in some measure all socialists" (p. 4), we are in great danger of repeating what happened in Germany under Hitler. Our liberal or, as Hayek prefers to say, socialist policies, if continued, will lead to totalitarianism.[4]

Hayek identifies collectivism, socialism, and planning; he defines planning as "a central direction of all economic activity according to a single plan, laying down how the resources of society should be 'consciously directed' to serve particular ends in a definite way" (p. 35). He believes that it is dangerously wrong to assume "that it must be possible to find some middle way between 'atomistic' competition and central direction. . . . Although competition can bear some admixture of regulation, it cannot be combined with planning to any extent we like without ceasing to operate as an effective guide to production" (p. 42).

Nevertheless, as Hayek does not advocate laissez faire, he is to that extent himself advocating some sort of compromise. He says that there is "all the difference between deliberately creating a system within which competition will work as beneficially as possible and passively accepting institu-

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[2] F. A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944). For critical appraisals of Hayek's book, see the following: E. F. M. Durbin, *Problems of Economic Planning* (London: George Routledge & Sons, Ltd., and Kegan, Paul, Trench, Trubner & Co., Ltd., 1949), Paper 5; Hermann Finer, *Road to Reaction* (Boston: Little, Brown and Company, 1946); Howard S. Ellis, "Postwar Economic Policies," *Review of Economic Statistics*, Vol. XXVIII (1946): Alvin H. Hansen, *Economic Policy and Full Employment* (New York: McGraw-Hill Book Company, Inc., 1947), Appendix A; Carl Landauer, *Theory of National Economic Planning* (Berkeley and Los Angeles: University of California Press, 1947); Barbara Wootton, *Freedom under Planning* (Chapel Hill: University of North Carolina Press, 1945).

[3] Page numbers in parentheses refer to Hayek, *op. cit.*

[4] The term "liberal" is used above, as it generally is in the United States, for policies which try to "correct" the capitalist economy. When Hayek uses the term he means almost the opposite.

show, however, that Hayek belongs to the group of neo-liberalists whose ideas were followed in West Germany after 1948.

When Hayek turns against a "mixed" system he is right to the extent that a system without either market or central plan lacks consistency in allocating factors of production. He is also correct as long as he argues against the uncoordinated price and quantity controls which can ruin the market economy before a central administration has been substituted for the functioning of the market; and, like his teacher Mises, he is right in implying that a system of central administration lacks the data for the most economical allocation of resources.

But the reader of *Road to Serfdom* is not informed which policies are to be used if the "immense possibilities for advancement over the cruder principles of the nineteenth century" are to be realized.

What are we to do about the recurrent waves of unemployment? What monetary and fiscal policies does Hayek suggest? How much social security can be provided? And how, specifically, are we to plan for competition? In no instance does Hayek commit himself; but he severely criticized those who try to solve these problems and whom he calls, for this reason, socialists. Yet he lets it be inferred that the same problems would somehow be solved in his market economy.

We can agree with Hayek that wrong policies were often employed—policies which failed to solve our problems and instead weakened the whole system. Seeing these mistakes and these dangers, Hayek should have shown in terms of concrete examples which policies were wrong, why they were wrong, and how they harmed the economy. Instead, he deals in generalities which are not always convincing.

Hayek is right when he deplores the fact that our understanding of the price mechanism is not always adequate. We also have to agree with him when he argues that the more complex society becomes, the more necessary it is to rely on the impersonal system of prices. But Hayek does not even mention the maintenance of aggregate expenditure, the basis of modern governments' full-employment policies. If Hayek does not agree with the Keynesian development in economic theory, he should say why he is opposed to this new approach and to the policies of aggregate spending which are derived from it.

Hayek's definitions of collectivism, socialism, and totalitarianism are insufficient. He admits that "the various kinds of collectivism, communism, fascism, etc., differ among themselves in the nature of the goal toward which they want to direct the efforts of society." They have in common, however, that "they all differ from liberalism and individualism in wanting to organize the whole society and all its resources for this unitary end and in refusing to recognize autonomous spheres in which the ends of the individuals are supreme. In short, they are totalitarian in the true sense of this new word which we have adopted to describe the unexpected but never-

tions as they are Probably nothing has done so much harm to the liberal cause as the wooden insistence of some liberals on certain rough rules of thumb, above all the principle of laissez faire" (p 17). Hayek goes so far as to admit that there are still 'immense possibilities of advancement" available over and above "*the crude rules in which the* principles of economic policy of the nineteenth century were expressed" (p 18) He demands that we plan for, rather than against, competition, is willing to concede a minimum of social security through protection against sickness and accident, and at least mentions "the supremely important problem of combating general fluctuations of economic activity and the recurrent waves of large scale unemployment which accompany them" (p 121) By remaining rather vague when making these suggestions, Hayek avoids having to show how these aims can be reached without some of the controls against which much of his book is directed He does, however, make it clear that we should not try to guarantee a given standard of life to special persons or groups, arguing rightly that such action would lead to only greater in-*security for other people* "*If you guarantee to some a fixed part of a vari* able cake, the share left to the rest is found to fluctuate proportionally more than the size of the whole" (p 128)

Hayek is afraid that what has been achieved in the past is regarded as a secure and imperishable possession, acquired once and for all (p 19), that "interest in and understanding of the functioning of the existing society rapidly declined," and that 'with the decline of the understanding of the way in which the free system worked, our awareness of what depended on its existence also decreased' (p 20) He refers, in particular, to the belief that "the increasing difficulty of obtaining a coherent picture of the complete economic process makes it indispensable that things should be co ordinated by some central agency if social life is not to dissolve in chaos" (p 48) According to Hayek, this argument is based "on a complete misapprehen sion of the working of competition The more complicated the whole, the more dependent we become on the division of knowledge between in dividuals whose separate efforts are co-ordinated by the impersonal mechanism for transmitting the relevant information known by us as the price system Compared with this method of solving the economic problem by means of decentralization plus automatic co-ordination, the more ob vious method of central direction is incredibly clumsy, primitive, and limited in scope" (pp 48 50)

Hayek concludes that 'the state should confine itself to establishing rules applying to general types of situations and should allow the individuals freedom in everything which depends on the circumstances of time and place, because only the individuals concerned in each instance can fully know these circumstances and adapt their actions to them" (p 75)

These quotations from Hayek's book are not meant to give a complete picture of his argument, which often transcends the field of economics They

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theless inseparable manifestations of what in theory we call collectivism" (pp 56-57) Since liberal socialism is definitely included when Hayek speaks of collectivism, we can well understand why liberal socialists were indignant There is a great deal of difference between pointing to a danger and taking it for granted that the worst expectations are already fulfilled.

Hayek is correct where he severely censures the tendency of trying to protect everybody against all hazards of economic life, but he forgets that this tendency is not typical only of socialism We have had much of this in capitalism The pressure groups who asked for special privileges—farmers, businessmen, and labor leaders—were not socialists As a matter of fact, the central planner is not likely to set up a system of entrenched privileges, because such a procedure would decrease the possibilities of planning even more than individual freedoms would

In spite of these criticisms, we should remember that Hayek has drawn our attention to a problem which must be uppermost in our minds There *is* danger If the working of the price mechanism is not understood, if direct controls are permitted to multiply, if inflation is repressed and if welfare state aims are allowed to tax the productive power of the nation, the combined effects of these aims and measures may be so bad that governments are tempted into a belated central administration of their uncoordinated *ad hoc* measures, and such central administration may mean totalitarianism.

Agenda and Non-agenda of Government

Totalitarianism, however, could also be the result of failure to correct the weaknesses of a market economy Hayek and others have been right in blaming those who have lost all faith in the market economy But equally mistaken are those who expect too much of the market economy, particularly when the market mechanism is not permitted to function properly

John Maynard Keynes said in his essay *The End of Laissez Faire* that "perhaps the chief task of Economists at this hour is to distinguish afresh the *Agenda* of Government from the *Non-Agenda*' and that 'the companion task of Politics is to devise forms of Government within a Democracy which shall be capable of accomplishing the Agenda" [5] Keynes knew, of course, that hardly anybody still believed in laissez faire But when he wrote his essay in 1926 he had good reasons to fear that those who were responsible for England's currency policy had set for the market economy a task which the latter could "solve" only with catastrophic consequences Keynes did not argue that we should give up the market economy He only wanted to protect it against those who trusted blindly in the market economy's resilience and who attempted to make it solve what were insoluble

[5] John Maynard Keynes 'The End of Laissez Faire" in *Essays in Persuasion* (New York Harcourt, Brace and Company, Inc, 1932), p 313

problems. Even then, however, Keynes expressed the conviction "that Capitalism, wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight, but that in itself it is in many ways extremely objectionable." [6]

Why did capitalism need wise management? Why was it extremely objectionable without this management?

For an example, let us recall the British economic situation in 1926. In reintroducing the gold standard, Churchill, as Chancellor of the Exchequer, had chosen the prewar dollar parity in spite of the fact that it did not correspond to the so-called purchasing power parity. English prices had risen considerably more than prices in the United States. Return to the prewar parity under these conditions meant that normal trade relations would be possible only if England could manage to lower its costs and prices. Keynes was of the opinion that this deflationary policy expected too much of the market economy and its ability to adjust wages downward. Under the assumption of wage rigidity, Keynes was skeptical about the feasibility of the gold standard in general;[7] but a combination of gold standard and overvaluation he considered much worse. He was right. It is hard to understand why the British economy was subjected to the ordeal of deflation.

The effects of Churchill's currency policy are well known.[8] Keynes had been right when he anticipated that a lowering of money wages would require dangerous deflationary pressures and would result in strikes and unemployment.

The same assumption led Keynes to conclude ten years later, in his *General Theory,* that a market economy could find its equilibrium position at an underemployment level. This conclusion was not new or revolutionary, for classical price theory had to come to the same result if wage rigidity was assumed.[9] Economic equilibrium at full employment presupposes adjustable wages.

It would be wrong to blame Keynesian economics for these wage rigidities. The question is only whether economic policy should be adjusted to political facts like wage rigidities, e.g., whether deflation or depreciation should be used. These are no longer questions of theory but are rather questions of political realism.

What Keynes doubted was the resilience of the market economy. His

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[6] *Ibid.*, p. 321.

[7] John Maynard Keynes, "Alternative Aims of Monetary Policy," in *Essays in Persuasion*, pp. 186 ff.

[8] See John Maynard Keynes, "The Economic Consequences of Mr. Churchill," in *Essays in Persuasion*, pp. 244 ff.

[9] See Gottfried Haberler, "The Place of the General Theory of Employment, Interest, and Money in the History of Economic Thought," *Review of Economic Statistics*, 28, (1946), 187 ff. Neither was Keynes' emphasis on the possibility of oversaving as new and revolutionary as some people think. We can find the same view ninety years earlier in John Stuart Mill's *Principles of Political Economy* (London: Longmans, Green & Co., 1936), Book V, Chap. 2, paragraph 7.

doubt was once more justified in the German reparation case Keynes predicted that the deflation which was to produce the excess of exports over imports could be had only at the price of unemployment, and again he was right [10]

We have already studied Keynes' *General Theory* and the policy proposals which were derived from it [11] "Keynes' great contribution was that he strongly emphasized the income factor and used it much more systematically in the analysis of economic change than had ever been done before " [12] Subsequent exaggerations and mistakes in government economic policy led some economists to criticize Keynes' theory as being exclusively interested in aggregates to the detriment of an understanding of the pricing process But as far as Keynes himself was concerned, this criticism was not justified The new emphasis on national income was closely connected with price theory Keynes did not want to replace the market mechanism, he wanted to create conditions in which this mechanism would lead to high employment levels with as little inflation as possible

Exaggerations and mistakes on the part of Keynes' disciples can be explained by the fact that the understanding of the market mechanism was at a low tide when the *General Theory* was published This theory can be said to have fallen in a vacuum, as far as the understanding of the market economy was concerned For an explanation of this situation we can refer to the same factors which were listed to explain why the economic theory of socialism remained undeveloped for so long [13]

Keynes did not advocate nationalization, though he spoke of "a somewhat comprehensive socialization of investment" [14] as the only means of securing an approximation to full employment The context shows that he did not advocate public ownership but merely some regulation of aggregate expenditure Conservative economists and some of Keynes' disciples overlooked the fact that Keynes believed that in times of high employment a *low* propensity to consume is conducive to the growth of capital [15]

Because the Keynesian theory grew out of the great depression, it dealt mainly with depression problems and proposed remedies which were anti-deflationist Some of the inflationist mistakes of the post World War II period can undoubtedly be traced to the fact that the young generation of "Keynesians" had not gained immunity against the inflation virus But Keynes himself explained the neutrality of his theory in his last book, *How*

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[10] John Maynard Keynes "The German Transfer Problem " *Economic Journal* Vol. XXXIX (March 1929)
[11] See Chapters 8 and 9 above
[12] Haberler *loc cit* p 190
[13] See above Chapter 14 pp 159 160
[14] John Maynard Keynes *The General Theory of Employment Interest and Money* (London Macmillan and Co Ltd, 1936), p 378
[15] *Ibid*, p 373

to Pay for the War.[16] We should also remember that some of the sharpest criticism of the deficient market orientation of the Labor party's postwar economic policies came from Keynesians like Harrod and Meade.[17]

When Keynes reminded his contemporaries that classical economics contained some permanent truths of great significance and that natural forces or even the "invisible" hand were operating toward equilibrium,[18] this remark was interpreted by some as recantation of his former theories. But only those who had never read the last chapter of the *General Theory* could come to this wrong conclusion. For there he expressly states that "if our central controls succeed in establishing an aggregate volume of output corresponding to full employment as nearly as is practicable, the classical theory comes into its own from this point onwards" and that "there is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them." [19]

Keynes' theory, when correctly interpreted, does not lead to policies which might ruin the pricing process and lead eventually to central planning and dictatorship. It is interesting to note that Keynes called Hayek's *Road to Serfdom* "a grand book." He wrote to Hayek,

> We all have the greatest reason to be grateful to you for saying so well what needs so much to be said. You will not expect me to accept quite all the economic dicta in it. But morally and philosophically I find myself in agreement with virtually the whole of it; and not only in agreement with it, but in a deeply moved agreement.[20]

Hayek, on his part, seems to have accepted at least some of Keynes' arguments. Although he says that he considers it a dangerous legacy of Keynes' great influence that we tend today to distinguish only between full employment and a state of affairs in which unemployed factors of all kinds are available, he continues, "Only few will deny that credit expansion can only be considered useful as long as a condition of *general* unemployment exists, in the sense that unused means of every kind are available." [21] It

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[16] John Maynard Keynes, *How to Pay for the War* (New York: The Macmillan Company, 1940).

[17] See, e.g., R. F. Harrod, *Are These Hardships Necessary?* (London: Rupert Hart-Davis, 1947), and J. E. Meade, *Planning and the Price Mechanism* (London: George Allen & Unwin, 1948).

[18] John Maynard Keynes, "The Balance of Payments of the United States," *Economic Journal*, LVI (1946), 186. See also Chapter 2, above, p. 16.

[19] Keynes, *General Theory*, pp. 378-379.

[20] R. F. Harrod, *The Life of John Maynard Keynes* (New York: Harcourt, Brace and Company, Inc., 1951), p. 436.

[21] F. A. Hayek in *Vollbeschäftigung, Inflation und Planwirtschaft* (Erlenbach-Zürich: Eugen Rentsch Verlag, 1951), p. 186.

must be douhted that Hayek would have made the latter statement without Keynes influence

Keynes planning for the maintenance of aggregate demand is as *important* for the functioning of the market economy as is Hayek's planning for competition Both types of planning can be so designed that the policies involved do not interfere unduly with relative price relations Both types of controls should he of the indirect type as far as possible They concern the nature of the environment which the free play of economic forces requires if it is to realize the full potentialities of production",[22] they erect around the existing mechanisms "so to speak, a system of laws and institutions within which they may be made to work in the right way",[23] and they create conditions under which the knowledge and initiative of individuals are given the hest scope so that *they* can plan most successfully "[24]

The designing of these central controls will not be an easy joh, it will require ahove all, a great amount of restraint Interference with the working of the price mechanism must be reduced to a minimum Our policies must be so designed that they work through, rather than against, the market, our controls in other words, must be, as far as possible, indirect rather than direct Direct controls often concern only a small section of the economy and are liable to be put into action with little regard to what their effect on the rest of the economy might be With indirect controls this situation is less likely though by no means impossible

Lionel Robbins is right in saying, "In the excitement of perfecting our instruments of analysis we have tended to neglect the study of the framework which they assume There is an urgent need for the best minds of the rising generation to apply themselves to this task of institutional invention in the light of patient, realistic investigations'[25]

It should be possible to create a system in which the agenda of the government are so carefully designed that each policy is a logical part of the whole, in which the many inconsistencies of direct controls are removed, and where private enterprise, guided by the market, can fulfill the task which *totalitarianism can accomplish only at* the *appalling cost of important* human freedoms

There will always he very special cases in which we shall have to violate our hasic principles, just as there is always a puhlic sector in which the working principles of the private sector cannot he applied In such cases we should make doubly sure that anything which impedes rather than supports the normal functioning of the price mechanism is worth the cost.

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[22] Keynes *General Theory* p 379

[23] Lionel Robbins, *The Economic Problem in Peace and War* (London Macmillan & Co Ltd., 1947), p 83

[24] Hayek, *op cit* p 35

[25] Robbins *op cit* p 84 The task is well outlined in Robert A Dahl and Charles E. Lindblom *Politics Economics and Welfare* (New York Harper & Brothers Publishers, 1953)

Aware of the chain reaction by which direct controls tend to spread, we must be at least as careful with these bureaucratic devices as with the spending of the taxpayers' money. Where we spend money, we are clearly aware of the costs. Where we create artificial protection we often meet no budgetary expense, but the social costs may be very great.

Of course, a system which rests mainly on the market will entail a certain amount of economic insecurity for its members. Because, however, a high level of employment will remove the worst cause of insecurity, this price should not be too high to pay for individualism whose advantages Keynes set forth so beautifully in the last chapter of his *General Theory*.[26]

> But, above all, individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice. It is also the best safeguard of the variety of life, which emerges precisely from this extended field of personal choice, and the loss of which is the greatest of all the losses of the homogeneous or totalitarian state. For this variety preserves the traditions which embody the most secure and successful choices of former generations; it colours the present with the diversification of its fancy; and, being the handmaid of experiment as well as of tradition and of fancy, it is the most powerful instrument to a better future.

[26] Keynes, *General Theory*, p. 380.

THE ABSTRACT PRICING PROCESS

Cassel's Abstract Model

The free exchange economy discussed in Chapter 3 is a model of the capitalist economy Would what we have learned about the pricing process be partially applicable to other economic systems? Could we change the most basic assumption on which the free market economy rests (private property of the material means of production) and still maintain the consistency of its price relations?

The answer to these questions is of great importance to comparative economic analysis If the pricing process of the free market economy can be made to work in a different institutional framework, for instance, in an economy with government ownership of the material means of production, the socialist economy can be designed as a market economy rather than a centrally planned economy In this case it may be possible to maintain a degree of freedom in the socialist state which would be incompatible with *totalitarian* planning

But even in the totalitarian planned economy the pricing problem will arise We have seen in Chapter 2 that even the centrally planned dictatorship economy would have to solve the problem of integrating successfully the productive efforts of millions of persons Mere reference to a central plan does not solve this problem No man, no board is wise enough to coordinate the thousands of production processes in which millions cooperate How can this coordination and integration be achieved? Will not even the centrally planned economy have to use some methods of consistent calculation? Will not the government managers need the guidance of prices?

The answers to these questions are difficult and will not be attempted at this stage of our analysis [1] Whether the pricing process can be applied to

[1] See, however, Chapters 18 to 20, below

other social economies should, however, be briefly discussed at this point, because we have already achieved so high a level of abstraction.

An answer to this question has been attempted by Gustav Cassel, who believes that he has succeeded in providing a model of the pricing process which is abstract enough to fit any kind of social economy, whether capitalist or socialist (132).[2]

Cassel takes "the exchange economy in the widest sense, stipulating only that it shall allow the individual freedom of occupation and freedom of consumption within the limits imposed by his means" (132). The principles of pricing, therefore, "hold good for every exchange economy, and are independent of the particular organization of production within the economy. . . . These principles would remain unchanged in an exchange economy in which the State had assumed control of production and reserved for itself the ownership of the material factors of production" (132).

In this socialist economy "the demand of consumers is indirectly a demand for factors of production, which . . . can be adequately restricted only by placing suitable prices on the factors of production. The principle of scarcity thus has exactly the same application to the socialist economy as to the present system . . ." (135).

However, the institutions of Cassel's socialist economy differ considerably from those found in the capitalist market economy. To select only a few points: The producing units are publicly owned, but we are not told how the necessary decisions are made. Competition does not seem to play a major part in the pricing process because Cassel wants to show "how untrue it is that free competition is a theoretically necessary condition for giving effect to the principle of cost . . ." (132-133). Prices are not always determined by the market; rather they are "set," but we are not told by whom. We shall see that Cassel replaces the driving forces of the market (*acquisitiveness and competition*) *through the commands of abstract principles*.

Such a system is possible in the abstract. Whether its "teleological" relations (i.e., relations requested to exist in furtherance of a stated purpose) can be translated into practical working principles, without reproducing at the same time the essential features of the capitalist economy, is a difficult question. On the solution of this question may depend the possibility of constructing an economy which avoids the capitalist feature of private property in the material means of production and the totalitarian feature of an all-inclusive plan.

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[2] Page numbers in parenthses refer to Gustav Cassel, *The Theory of Social Economy* (New York: Harcourt, Brace and Company, Inc., 1932).

Cassel's Arithmetical Treatment of the Problem of Equilibrium

Cassel coosiders first the simple case where "the quantities of goods avail able to consumers in a particular period are given' (138) This case resembles a dictatorship economy in which the decision of what to produce is made independently of the wishes of the consumers, but where the con sumers are free to buy commodities if they are willing to pay the price which equalizes demand and supply In other words, Cassel assumes at first free choice of consumption but not consumers sovereignty

Cassel also assumes that the sum of money which each consumer spends during the relevant period for the satisfaction of his wants is fixed in ad vance The demand of each consumer for the various commodities during the period is thus settled as soon as the prices of these articles are known As we add the demands of the individuals, we get the total demaod for each commodity The demand for a commodity does not depend solely oo its own price, it depends also on the prices of all other commodities If the price of shoes goes down, we may be inclined to buy another pair of socks, if the price of cigarettes increases we may cut down on buying magazines

Demand is a table which sets forth the amounts of a commodity which are purchased at different prices and indicates, therefore, the relation between two variables amounts purchased and prices This relation we call 'demand function" We have seen, however, that the demand for a com modity is influenced, in addition, by changes of prices of other goods, since these changes either set free or absorb purchasing power, depending on the elasticities of demand for these goods No price can change without potentially influencing the demand for all other commodities

> The total demand of consumers in the aggregate for any partic ular commodity is thus determined by the prices of the n commodities If we represent the total demand for the n commodities in the given period by $D_1, D_2 \cdots D_n$ we can then express these magnitudes as functions of the n prices, thus
>
> $$(1)\quad \begin{aligned} D_1 &= F_1\,(p_1 \cdots p_n) \\ D_2 &= F_2\,(p_1 \cdots p_n) \\ \\ D_n &= F_n\,(p_1 \cdots p_n), \end{aligned}$$
>
> where $p_1 \cdots p_n$ are the prices of the n commodities
>
> Now, the demaod for any particular commodity, given a state of equilibrium must coincide with the supply of it, since the fixing of prices, in accordance with the principle of scarcity, must be such as to

restrict demand so as to satisfy it with the available supply of commodities. It follows therefore that:

$$D_1 = S_1,\ D_2 = S_2 \cdots D_n = S_n$$

and hence, according to (1):

$$\begin{aligned}
(2)\quad & F_1\,(p_1 \cdots p_n) = S_1 \\
& F_2\,(p_1 \cdots p_n) = S_2 \\
& \cdots\cdots\cdots\cdots\cdots\cdots \\
& F_n\,(p_1 \cdots p_n) = S_n \text{ (139-140).}
\end{aligned}$$

It is obvious that these equations have no precision. They do *not* enable us to calculate the prospective demand for shoes or typewriters, once we know the purchasing power of the consumers, the prices of shoes and typewriters, and the prices of all the other products which the consumers may also want to buy. The demand function depends on such elusive elements as individual tastes, which cannot be expressed with sufficient precision.[8]

Equilibrium exists according to Cassel when the demand for each article is equal to the "given" supply. He simply assumes that demand and supply "must" be equal. We note that he has not explained how equality between demand and supply has been reached. Our previous discussion of the market economy makes it easy for us to substitute the competitive solution. In the future we must be careful, however, not to use this substitution automatically when Cassel's institutional assumptions do not permit its further application.

According to Cassel, the "principle of scarcity" requires that the demand for all commodities be restricted until it can be met with the available supply. Since Cassel assumes as given both the supply of the commodities and the sum of money which each consumer can spend during a given period, he "solves" the pricing problem by setting on each commodity a price which equilibrates demand and supply.

To introduce the process of production, Cassel drops the assumption of a given supply of consumers' goods and takes, instead, the factor supply as given. The number of the different kinds of factors is r, and $R_1\ R_2 \cdots R_r$ are the available quantities of these factors (or their services) during a given unit period. The prices of the factors of production (or their services) are $q_1 \cdots q_r$.

Cassel's scheme no longer resembles a dictatorship economy, since it is now assumed that production follows the wishes of the consumers as expressed by the demand functions.

---

[8] See also T. J. B. Hoff, *Economic Calculation in the Socialist Society* (London: William Hodge & Company, Ltd., 1949), p. 132: "The author of this treatise can confirm that Halm is right and that Professor Cassel never regarded his equations as a basis for an arithmetical or a mathematical computation of prices, but merely as an expression of principles that are generally applicable to an exchange economy."

With the factors of production we produce commodities of n different kinds. The quantities of different factors needed to produce one unit of commodity 1 is the technical coefficient (a_1). We need a certain quantity of factor 1, another quantity of factor 2, perhaps nothing of factor 3, and so on until we reach factor r. Thus we can say that in order to produce a unit of commodity 1 we need $(a_1)1 + (a_1)2 + \cdots (a_1)r$. To produce a pair of shoes we need, e g, 5 minutes of one kind of labor, 2 minutes of another kind, a given amount of leather, etc. Similarly, we can express the technical coefficient in the production of commodity 2 as (a_2). To produce a unit of commodity 2 requires $(a_2)1 + (a_2) + \cdots (a_2)r$, and to produce a unit of commodity n: $(a_n)1 + (a_n)2 + \cdots (a_n)r$.

In equilibrium the commodity prices must be equal to the cost of production of the commodities Costs of production are known when we multiply the quantities of the different factors (used according to the technical coefficients) by the prices of the factors. These factor prices are $q_1 \cdots q_r$. According to equations

$$
\begin{aligned}
(3)\quad & (a_1)1q_1 + (a_1)2q_2 + \cdots (a_1)rq_r = p_1 \\
& (a_2)1q_1 + (a_2)2q_2 + \cdots (a_2)rq_r = p_2 \\
& \cdots\cdots\cdots\cdots\cdots\cdots\cdots\cdots \\
& (a_n)1q_1 + (a_n)2q_2 + \cdots (a_n)rq_r = p_n \quad (143),
\end{aligned}
$$

the prices of the n commodities are known.

Once the prices of the finished goods are known, however, then . . . the aggregate demand for each commodity in each unit period is known and can be calculated by means of the following series of equations:

$$
\begin{aligned}
(4)\quad & D_1 = F_1 (p_1 \cdots p_n) \\
& D_2 = F_2 (p_1 \cdots p_n) \\
& \cdots\cdots\cdots\cdots \\
& D_n = F_n (p_1 \cdots p_n)
\end{aligned}
$$

In accordance with the principle of scarcity, when prices are in equilibrium every demand must be satisfied by [illegible] and we thus get

$$(5)\quad D_1 = S_1,\ D_2 = S_2 \cdots D_n = S_n$$

where S_1, S_2, S_n are the quantities of each [illegible] produced within a u[illegible]

Thus we know [illegible] of the p[illegible] are to be produce[illegible] demands which are [illegible] unit period, let us [illegible] fo[illegible] produce in each un[illegible] tities $(a_1)1 \cdots (a_1$ [illegible]

S_1 we therefore require the quantities $(a_1)1S_1 \cdots (a_1)rS_1$. The same thing holds in the case of the remaining products. In all, therefore, for the continuous production of quantities $S_1 \cdots S_n$, we require

(6) the quantity $(a_1)1S_1 + (a_2)1S_2 + \cdots (a_n)1S_n$ of factor of production 1
the quantity $(a_1)2S_1 + (a_2)2S_2 + \cdots (a_n)2S_n$ of factor of production 2
. . . .
the quantity $(a_1)rS_1 + (a_2)rS_2 + \cdots (a_n)rS_n$ of factor of production r.

These quantities thus represent the indirect demand of consumers for the factors of production needed in each unit period in the continuous stationary society. In accordance with the principle of scarcity, this demand for each factor of production must be equal to the quantity of that factor available within the particular unit period, since it is the task of pricing to limit demand as far as is necessary for this purpose. Therefore

$$
\begin{aligned}
(7)\quad R_1 &= (a_1)1S_1 + (a_2)1S_2 + \cdots (a_n)1S_n \\
R_2 &= (a_1)2S_1 + (a_2)2S_2 + \cdots (a_n)2S_n \\
&\cdots\cdots\cdots\cdots\cdots\cdots\cdots\cdots \\
R_r &= (a_1)rS_1 + (a_2)rS_2 + \cdots (a_n)rS_n
\end{aligned}
$$

The S, in conformity with the series of equations (5) and (4), are here functions of the p, and therefore, from equations (3), functions of the q. The series of equations (7) thus contains as unknowns the r prices of the factors of production. It also contains r equations, and the series is thus in general sufficient for determining the unknowns. Once the prices of the factors of production are known, the prices of the products can be calculated in accordance with the series of equations (3). Similarly, the demand for each of the finished commodities in each unit period is obtained from the series of equations (4). Consequently, we can calculate the demands which are made on production. Equations (5) show how much of each particular commodity must be produced in each unit period which determines the distribution of the factors of production among the various branches of production. The requirements which the continuous demand, regulated by these prices, makes of the different factors of production available in a particular unit period are to be calculated according to formulae (6). The coincidence of these requirements with the available quantity of factors of production is guaranteed by equations (7). The pricing problem is thus completely solved for the case considered here" (143-145).

With the factors of production we produce commodities of n different kinds The quantities of different factors needed to produce one unit of commodity 1 is the technical coefficient (a_1) We need a certain quantity of factor 1, another quantity of factor 2, perhaps nothing of factor 3, and so on until we reach factor r Thus we can say that in order to produce a unit of commodity 1 we need $(a_1)1 + (a_1)2 + \cdots (a_1)r$ To produce a pair of shoes we need, e g, 5 *minutes* of one kind of labor, 2 minutes of another kind, a given amount of leather, etc Similarly, we can express the technical coefficient in the production of commodity 2 as (a_2) To produce a unit of commodity 2 requires $(a_2)1 + (a_2) + \cdots (a_2)r$, and to produce a unit of commodity n $(a_n)1 + (a_n)2 + \cdots (a_n)r$

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& \\
& (a_n)1q_1 + (a_n)2q_2 + \cdots (a_n)rq_r = p_n \quad (143),
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& D_2 = F_2\,(p_1 \cdots p_n) \\
& \\
& D_n = F_n\,(p_1 \cdots p_n)
\end{aligned}
$$

In accordance with the principle of scarcity, when prices are in equilibrium every demand must be satisfied by the supply, and we thus get

$$(5)\quad D_1 = S_1,\ D_2 = S_2 \cdots D_n = S_n,$$

where S_1, S_2, S_n are the quantities of each of the different commodities produced within a unit period

Thus we know the quantities of the particular commodities which are to be produced in each unit period From this we can calculate the demands which are made upon the factors of production of a particular unit period, let us say the present, as follows In order constantly to produce in each unit period a unit of commodity 1, we require quantities $(a_1)1 \cdots (a_1)r$ of these factors of production For the quantity

S_1 we therefore require the quantities $(a_1)1S_1 \cdots (a_1)rS_1$. The same thing holds in the case of the remaining products. In all, therefore, for the continuous production of quantities $S_1 \cdots S_n$, we require

(6) the quantity $(a_1)1S_1 + (a_2)1S_2 + \cdots (a_n)1S_n$ of factor of production 1
the quantity $(a_1)2S_1 + (a_2)2S_2 + \cdots (a_n)2S_n$ of factor of production 2
. . . .
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These quantities thus represent the indirect demand of consumers for the factors of production needed in each unit period in the continuous stationary society. In accordance with the principle of scarcity, this demand for each factor of production must be equal to the quantity of that factor available within the particular unit period, since it is the task of pricing to limit demand as far as is necessary for this purpose. Therefore

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&\cdots\cdots\cdots\cdots\cdots\cdots\cdots\cdots \\
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\end{aligned}
$$

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Finally Cassel drops the assumptinn that the quantity of money every consumer spends is fixed in advance Incomes are now determined by the pricing process itself "The problem nf distribution is, therefore, not an independent problem , but is to be regarded essentially as a special aspect of the general problem of prices (151)

Critical Remarks

We have seen that there are three exngennus factors which may disturb the equilibrium position of a social economy changes in tastes in factor supply, and in technical know how Cassel s scheme can be used to illustrate how any one of these disturbances will affect the whole system Take a change in tastes which will affect the demand function With a change in demand, supply must change A change in production affects the demand for the factors of production and the factor prices A change in factor prices influences the prices of finished goods, and these price changes, in turn, affect demand and supply, and so on *ad infinitum* until the surface of the pool into which we throw the stnne regains its previous unruffled surface

A change in production techniques will change the technical coefficients, the demand for factors, the prices of the finished products, the spending power of the consumers, demand, supply, again the demand for factors, and so on

An interesting example of the re-establishment of a disturbed equilibrium is the essence of Bertil Ohlin's book *Interregional and International Trade*[4] Two isolated countries have found their individual equilibrium positions This equilibrium is destroyed through the beginning of international trade Factor prices are dissimilar in the two regions, owing to different endowment of the countries with the various factors of production Product prices must be dissimilar, too, and these price differences invite international trade When the price systems of the twn countries are linked together by a rate of exchange between their currency units, the differences in product prices must lead tn exports and imports and to adjustments of prices, costs, and production, until a new equilibrium is achieved at a rate nf exchange which balances exports and imports

Cassel succeeds in giving a lucid picture nf the interdependence of all prices We have to remember, hnwever, that Cassel does not want to depict the basic structure nf the capitalist system but rather the fundamental relationships in any exchange economy This be can do only on so high a level of abstraction that the indicated relatinnships are nf a purely teleological nature But for a working model of the social economy it is not enough to show what *must* be done The model of nur free market economy made it

[4] Bertil Ohlin *Interregional and International Trade* (Cambridge Mass Harvard University Press, 1933), Chaps 1, 2 and Ap I

clear that under the pressure of acquisitive and competitive propensities the members of the economy acted in such a way that the system tended toward equilibrium. In Cassel's scheme the equilibrium position is stated as an aim, but we are not told which forces can be relied upon to accomplish the task which real exchanges on real, competitive markets accomplish in the free market economy.

Cassel does not introduce the businessman who controls the business unit, nor is his place taken by a public manager. The whole scheme consists of abstract requests addressed to abstract units of production and consumption. The scheme shows what the inner structure of an abstract system of equilibrium would have to be. But it gives no inkling how in the real world this state of equilibrium is to be achieved. The reader may not notice this because Cassel starts, realistically enough, with consumer income and consumer buying on the market. But since he suggests that the government will take over production, it is difficult to see how the process of pricing is to be carried out in markets (if they can be called markets at all) where sellers as *well* as buyers are government agencies.

However, Cassel is not even quite consistent in his tendency to generalize. He does not do full justice to the completely abstract character of his model. His teleological system does not have to rest on free consumers' and occupational choices. This assumption enables Cassel to begin with a real consumers' goods market. But he soon gives up the pretense of discussing real markets and replaces markets by certain principles which have to be fulfilled. Now, if we can dispense with the market for the government owned material means of production, we can as well dispense with the rest of the markets and replace their function by requests that the scarcity and cost principles have to be fulfilled throughout the economy. This means that Cassel's scheme can cover not only the "exchange" economies but equally any social economy based on the command principle. The important difference emerges not on this abstract level but only when we try to make the model work in real life under the various institutions of different social-economic systems.

The totalitarian socialist economy substitutes the dictator's scale of values for the consumers' ballots. However, it faces the same basic problem that any other social economy has to meet: the factors of production must be allocated to different industries in such a way that the dictator's aims are achieved in the most economical manner. Cassel's scheme shows what the totalitarian economy would have to do, though it does not show how it would do it.

That Cassel's assumptions are not abstract enough can be seen when he discusses problems of income distribution. The way in which he derives the determination of personal incomes from the prices of the factors is too narrow and does not take account of the fact that the government owns the material means of production. As a matter of fact, in such an abstract

scheme we should be able to divorce "functional" distribution completely from "personal" distribution

Applied to the planned economy in Russia, Cassel's abstract pricing process would point to the following important features

As far as consumers' goods are concerned, the Russian economy corresponds to Cassel's "simple" case in which the supply is already given The prices of the consumers' goods equate demand and supply But production does not follow the command of the consumers The consumers' choices have been replaced by the choices of the planners Scarcity of consumers' goods leads to high prices, and the difference between high prices and substantially lower costs of production is equal to a turnover tax which (together with planned and unplanned profits) finances capital accumulation

Where real markets are not available to equalize demand and supply, this equalization is the result of material and financial "balances" The planners have to make sure that each production process can count on the allocation of all the means of production which are required because of the technical coefficient and the output quota which must be reached In turn, the output of each individual industry must be high enough to supply all other industries (or the consumers) with the needed allocations

Russia's material balances correspond to Cassel's request that the factors of production be allocated according to the technical coefficients of the industries and according to the supply of the different products, in such a way that full employment of all factors is achieved

But material balances are not sufficient, because different physical things are incomparable We gain, both in Russia and in Cassel's scheme, financial balances when we multiply the factor units with factor prices In this way costs find a common denominator and can be compared with product prices

In Cassel's scheme the consumer is the final judge whose demand functions are decisive In Russia these demand functions are replaced by the decisions of the planners But if the planners want to act rationally, they have to see to it that the internal relations of the planned economy resemble the consistent logic of the Casselian scheme the factors must be fully employed, they must be employed where the value of the product corresponds to the costs, and all individual production processes must be able to count on a sufficient allocation of factors if they are to reach their respective quotas That they reach their quotas is imperative since they, in turn, are counted upon to supply other parts of the economy with the necessary intermediate or final products

We see that the elimination of consumers' sovereignty does not alter the fact that the social economy must establish consistent interrelations between all its production processes

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